Federal Register

Friday,
December 1, 2000

Part IV

Securities and Exchange Commission

17 CFR Part 240

Disclosure of Order Execution and Routing Practice; and Firm Quote and Trade-Through Disclosure Rules for Options; Final Rules

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–43590; File No. S7–16–00]

RIN 3235–AH95

Disclosure of Order Execution and Routing Practices

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting two rules to improve public disclosure of order execution and routing practices. Under Rule 11Ac1–5, market centers that trade national market system securities will be required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 11Ac1–6, broker-dealers that route customer orders in equity and option securities will be required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers will be required to disclose to customers, on request, the venues to which their individual orders were routed. By making visible the execution quality of the securities markets, the rules are intended to spur more vigorous competition among market participants to provide the best possible prices for investor orders.

DATES: *Effective date:* January 30, 2001.

Compliance dates: For specific phase-in dates for compliance with the rules, see section V of this release. In addition, the national securities exchanges and the national securities association subject to § 240.11Ac1–5(b)(2) shall comply with that provision by submitting a national market system plan to the Commission by no later than February 15, 2001.

FOR FURTHER INFORMATION CONTACT: Susie Cho, Attorney, at (202) 942–0748, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Introduction

The Securities and Exchange Commission (''Commission'') is adopting two rules to increase the visibility of execution quality of the U.S. securities markets for public investors.[1] Market centers that execute investor orders will be required to make monthly disclosures of basic information concerning their quality of executions. Broker-dealers will be required to disclose the identity of the market centers to which they route orders on behalf of customers. Taken together, the rules should significantly improve the opportunity for public investors to evaluate what happens to their orders after they submit them to a broker-dealer for execution.

The rules arise out of the Commission's extended inquiry into market fragmentation—the trading of orders in multiple locations without interaction among those orders. In today's markets, investor order flow in the same security can be divided among many different ''market centers''—*e.g.,* exchanges, over-the-counter (''OTC'') market makers, and electronic communications networks (''ECNs''). The primary structural component linking these market centers in the national market system is the consolidated public quote. Pursuant to Commission rules, the best displayed bid and offer for each equity security are collected from all significant market centers and disseminated to the public on a real-time basis. This centralized source of information, however, may convey an inaccurate impression of the significant extent to which the quality of order execution can vary across different market centers. At some market centers, for example, as many as 50% of certain orders, particularly market orders for small sizes (less than 500 shares), are executed at prices *better* than the public quotes. Similarly, for investors seeking to use limit orders to obtain better prices than the public quotes, there can be wide variations among market centers in the opportunity for such orders to be executed.

At present, few market centers provide detailed public disclosure concerning their execution quality. Rule 11Ac1–5 will assure that all market centers publicly disclose, on a monthly basis, basic standardized information concerning their handling and execution of orders. Such information will include, for example, how market orders in various size categories are executed relative to the public quotes. Also, investors for the first time will be informed not just about quoted spreads,

[1] The two rules, 17 CFR 240.11Ac1–5 and 17 CFR 240.1Ac1–6, were proposed for public comment in Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406 (''Proposing Release''). Section 11A of the Securities Exchange Act of 1934, 15 U.S.C. 78k–1, grants the Commission authority to promulgate rules necessary or appropriate to assure the fairness and usefulness of information on securities transactions and to assure that broker-dealers transmit orders in a manner consistent with the establishment and operation of a national market system. The principal national market system objectives set forth in section 11A(a)(1) include the efficient execution of securities transactions, fair competition among market participants, the public availability of information on securities transactions, and the best execution of investor orders. The rules adopted today should significantly further these objectives.

but also about *effective* spreads—the spreads *actually paid by investors* whose orders are routed to a particular market center. In addition, market centers will disclose the extent to which they provide to investors using limit orders executions at prices better than the public quotes.

To complement the improved public disclosure of execution quality by market centers, the Commission also is adopting a rule to improve disclosure of order routing by broker-dealers. Under Rule 11Ac1–6, broker-dealers that route orders as agent on behalf of their customers will be required to disclose, on a quarterly basis, the identity of the market centers to which they route a significant percentage of their orders. Broker-dealers also will be required to disclose the nature of their relationships with such market centers, including any internalization or payment for order flow arrangements, that could represent a conflict of interest between the broker-dealer and its customers. In the past, such information has been available, if at all, only by individual customer request on a transaction-by-transaction basis. As a result, there has been very little opportunity for the public to evaluate the routing practices of a broker-dealer as a whole.

In a fragmented market structure with many different market centers trading the same security, the order routing decision is critically important, both to the individual investor whose order is routed and to the efficiency of the market structure as a whole. The decision must be well-informed and fully subject to competitive forces. Currently, given the lack of comparable public information on execution quality, retail investors may conclude that the most rational strategy is simply to opt for a broker-dealer that offers the lowest commission and a fast execution. As a result, there may be limited opportunities for market participants to compete on their ability to obtain the best prices for these investor orders. By increasing the visibility of order execution and routing practices, the rules adopted today are intended to empower market forces with the means to achieve a more competitive and efficient national market system for public investors.

II. Disclosure as Minimum Step Necessary to Address Market Fragmentation

The Commission is adopting Rule 11Ac1–5 and Rule 11Ac1–6 primarily to address the serious problems that can arise from market fragmentation. For most stocks actively traded in the U.S. markets, there are a variety of market centers from which to choose in determining where to route orders for execution. Particularly for equity securities qualified for inclusion in the Nasdaq Stock Market, Inc. (''Nasdaq''), trading is widely dispersed among many different market centers. These include a large number of securities dealers that act as Nasdaq market makers. In September 2000, there were an average of 59 market makers per issue in the top 1% of Nasdaq stocks by dollar trading volume, 29 market makers per issue in the next 9% of stocks, and an overall average of 13 market makers per issue. In addition, eight ECNs operate agency markets, which together accounted for 25.8% of Nasdaq share volume in September 2000.[2] For exchange-listed equities, in contrast, the primary exchanges still retain a high percentage of order flow. In September 2000, for example, the New York Stock Exchange, Inc. (''NYSE'') accounted for 83.3% of share volume in NYSE equities.[3]

The Commission initiated its formal inquiry into market fragmentation in December 1999 when the NYSE submitted a proposed rule change to rescind Rule 390, its rule restricting off-board trading by NYSE members. In February 2000, the Commission issued a release that published the NYSE's proposal for public comment and also requested comment on a wide range of issues relating to market fragmentation (''Fragmentation Release'').[4] It noted that the rescission of off-board trading rules raised at least the potential for increased fragmentation of the market for exchange-listed stocks. The Commission particularly highlighted its concerns that dealer practices such as internalization and payment for order flow have contributed to the isolation of investor limit orders and to less vigorous quote competition.[5]

Among the commenters responding to the Fragmentation Release, the investors (both institutional and retail) were unanimous in their view that fragmentation was a problem that the Commission needed to address. Many securities industry participants, in contrast, believed that fragmentation merely was an inevitable adjunct of competition among market centers, and that such competition produces many benefits for investors. Although the comments reflected wide disagreement about a number of potential options for Commission action that would have addressed market fragmentation most directly, the majority of commenters supported some form of increased disclosure by market centers and broker-dealers concerning their execution quality and order routing practices. In July 2000, the Commission issued a release proposing Rule 11Ac1–5 and Rule 11Ac1–6 to implement this option (''Proposing Release'').[6]

In considering the issue of fragmentation, the overriding objective of the Commission's inquiry has been quite pragmatic—to assure that investors receive the best possible prices for their orders.[7] For example, do investors who seek liquidity by submitting market orders pay the lowest possible effective spread, or liquidity premium, for their orders? Similarly, do investors who supply liquidity by submitting limit orders have the best possible opportunity for their orders to be executed? The Commission believes that vigorous competition among buyers and sellers in an individual security, particularly through an opportunity for their orders to interact directly,[8] is the only reliable means to achieve the best prices for investors. To the extent that

[2] Source: NASD Economic Research Dept., *www.nasdaq.marketdata.com* (visited Oct. 31, 2000). It is doubtful that the emergence of agency market centers operated by ECNs has significantly worsened fragmentation in the market for Nasdaq securities. Since the creation of the Nasdaq market in the 1970's, order flow in such securities always has been fragmented among a significant number of market makers.

[3] Source: NYSE. In addition, the American Stock Exchange LLC (''Amex'') accounted for 69.9% of share volume in Amex equities during September 2000. Source: Amex.

[4] Securities Exchange Act Release No. 42450 (Feb. 28, 2000), 65 FR 10577. The Commission subsequently approved the rescission of Rule 390, in part because the rule had tended to restrict the competitive opportunities in listed securities of ECNs that operate agency markets. Securities Exchange Act Release No. 42758 (May 5, 2000), 65 FR 30175. It emphasized, however, that its desire to clear away any regulatory barriers to competition should not be interpreted as an indication of whether the ECNs would or should attractive a significant amount of listed market share. That will be determined by competition. The Commission also emphasized that its criticism of Rule 390 should not be interpreted as criticism of the quality of the NYSE's market, noting that studies repeatedly had demonstrated its high quality of execution and important public price discovery function. *Id.* at note 28 and accompanying text.

[5] These dealer practices are discussed in section IV.A.2 of the Fragmentation Release.

[6] Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406.

[7] Section IV.A.1 of the Fragmentation Release discusses the various ways in which investors seek to obtain the best prices, including the use of market orders by investors seeking liquidity and the use of limit orders by investors supplying liquidity. In addition, it discusses the alternatives used by large investors to interact with smaller orders (often by offering better prices for such orders) without being forced to display their full trading interest, which might move the market significantly against them.

[8] An opportunity for investor orders to be executed without the participation of a dealer is, subject to efficiency and best execution objectives, one of the five principal objectives for a national market system. Exchange Act section 11A(a)(1)(C)(v), 15 U.S.C. 78k–1(a)(1)(C)(v).

substantial fragmentation of order flow stands in the way of such competition, the harm that results is not merely theoretical. Rather, investors are forced to incur higher transaction costs, and the efficiency of the U.S. markets is diminished.

The Commission's concerns about fragmentation and order interaction should not be construed as meaning that it fails to recognize the essential importance of competition among market centers, which almost by definition entails some fragmentation of order flow. The Commission repeatedly has emphasized the substantial benefits to investors of such competition, including innovative trading services, lower trading fees, and faster executions. Accordingly, the relevant issue in addressing fragmentation is not whether the objective of order interaction should be pursued to the exclusion of market center competition, but how best to secure the benefits of both market center competition and order interaction. Although these two objectives may not be entirely congruous, they both serve to further the interests of investors and therefore must be reconciled in the structure of the national market system.

Determining how best to assure an appropriate balance between market center competition and order interaction is unquestionably a difficult task. Nevertheless, the Commission's year-long inquiry has led it to conclude that increased public disclosure of execution quality and order routing practices is a minimum step necessary to address fragmentation. There currently is little or no publicly available information that would enable *investors* to compare and evaluate execution quality among different market centers and order routing practices among broker-dealers. Some market centers make order execution information privately available to independent companies, which then prepare reports on execution quality that are sold to broker-dealers. Other market centers provide reports on execution quality directly to broker-dealers or to their members. The information in these reports generally has not been publicly disseminated. Moreover, some broker-dealers have reported difficulty in obtaining useful information on execution quality from market centers. For example, participants in a Commission roundtable on the on-line brokerage industry indicated that not all market centers were willing to make order execution information available and, even when such information was made available, not all of it was useful or in a form that allowed for cross-market comparisons.[9]

Consequently, most investors have few tools with which to assess the execution quality of different market centers and the order routing practices of different broker-dealers. Execution quality can, however, vary significantly across different market centers trading the same security. If improved disclosure leads to the tightening of effective spreads across market centers, the savings to investors could be quite substantial. For example, the Commission staff has estimated that investors who submit market orders for Nasdaq securities could save $110 million in annual trading costs if market centers that currently execute such orders at effective spreads wider than the median for all Nasdaq market centers improved their effective spreads to the median.[10] The variation of execution quality across market centers also has been shown by previous analyses of trading. In 1997, for example, the Commission issued a Report on the Practice of Preferencing that analyzed trading in the listed equity markets (''Preferencing Report''). The sole objective of the Preferencing Report was to evaluate the impact of two preferencing programs that had been formally implemented by the Cincinnati Stock Exchange (''CSE'') and Boston Stock Exchange.[11] In this limited context, the Preferencing Report found that the programs had not had an adverse effect on the national market system as a whole (particularly given that the programs were quite limited and represented only a small fraction of listed order flow).[12] When NYSE trading was compared directly with trading on the regional exchanges, however, and such comparisons were made on an ''apples-to-apples'' basis (*i.e.,* categorized by trading in the same stocks and by orders of the same size), the Preferencing Report found significant variations in executions across market centers.[13] For example, the effective spreads on the regional exchanges for small market orders were 20% to 39% higher than those on the NYSE.[14]

In addition to public analyses of equity market trading, the Commission staff is aware of similar data obtained during the examination process indicating that execution quality can vary across market centers. In 1999, for example, the Commission's Office of Compliance Inspections and Examinations (''OCIE'') conducted examinations of 21 broker-dealers for compliance with the firms' responsibility to examine regularly and rigorously the execution quality likely

[9] *See* Report by Commissioner Laura S. Unger, *On-Line Brokerage: Keeping Apace of Cyberspace* 40–41 (Nov. 1999) (available at *http://www.sec.gov*). One of the recommendations in Commissioner Unger's Report was that the Commission should consider requiring market centers to make publicly available certain uniform information on execution quality and requiring broker-dealers to provide their customers with plain English information about the execution quality available at different market centers, order handling practices, and the broker-dealer's receipt of inducements for order flow. *Id.* at 45. In addition, one of the largest broker-dealers noted in its comment letter on the Fragmentation Release that even it had been frustrated in its own attempts to obtain useful order execution data from certain markets. Letter from Lon Gorman, Vice Chairman and President, Capital Markets & Trading Group, Charles Schwab & Co., to Jonathan G. Katz, Secretary, SEC, dated July 5, 2000, at 7.

[10] This estimate is described in the cost-benefit discussion in section VII.A.1 below.

[11] The practice of preferencing, under which orders are directed to a particular exchange specialist that is entitled to take priority in execution over same-priced orders entered prior in time, is quite similar to internalization by OTC market makers.

[12] The Preferencing Report specifically noted (p. 172) that preferencing programs would require reconsideration if ''a significant increase in the amount of preferencing activity as a percentage of overall national market system activity'' resulted in the decline of execution quality on the national market system.

[13] Commenters on the Proposing Release correctly noted that the Preferencing Report found higher fill rates for non-marketable limit orders on the regional exchanges than on the NYSE. Letter from Jeffrey T. Brown, Vice President Regulation and General Counsel, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Sept. 25, 2000, at 9 (''CSE Letter''); Letter from Richard Brueckner, Chief Operating Officer, Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation, to Jonathan Katz, Secretary, SEC, dated Sept. 29, 2000, at 3 (''Pershing Letter''). The fill rates are reported in Tables V–17 and V–18 of the Preferencing Study. Only a small number of non-marketable limit orders, however, were routed to the regional exchanges, even when evaluated as a percentage of total order flow (and therefore adjusting for the much smaller share volume of the regional exchanges). *See* Preferencing Report, Table V–2 (regional exchanges' non-marketable limit orders represented 11.5% to 17.3% of their total order executions compared to 45.7% of NYSE executions). Indeed, the Preferencing Study found that four of the five largest broker-dealer participants in the CSE preferencing program (all that were examined) generally did not use the CSE's limit order book, but preferred either to place limit orders on their proprietary limit order books or to route the limit orders to the primary market. Preferencing Report at 114.

[14] Preferencing Report, Table V–7. In addition, Table V–11 indicates that, when compared for same stocks and order sizes, the NYSE average price improvement rate for small market orders was 45% to 180% higher than that of the regional exchanges. Analogous results were reflected in other tables (V–12, V–14, V–15, V–16) that were adjusted for trading in the same stocks and order sizes. Most of the tables in the Preferencing Report, however, compared NYSE trading for one week in all of its stocks with regional exchange trading for four weeks in a smaller number of NYSE stocks. They therefore did not attempt to capture distinctions between trading in comparable stocks during the same time period, as will be facilitated by the monthly market center reports to be made available under Rule 11Ac1–5.

to be obtained from different market centers. In the course of these examinations, OCIE found that the firms had obtained private analyses of trading from independent companies showing marked differences in execution quality among market centers trading the same security, as well as across securities traded in different market structures.

The Commission anticipates that the two rules adopted today could provoke more vigorous competition on execution quality and order routing performance. The rules will reveal if broker-dealers are routing a significant volume of orders to market centers that execute orders at prices substantially inferior to those available at other market centers trading the same security. This improved visibility, in turn, could shift order flow to those market centers that consistently generate the best prices for investors. Finally, by facilitating comparisons among securities traded in different market structures, the disclosures required by the rules may bring competitive forces more directly to bear on broader market structure issues, such as by prompting investors and issuers to choose markets with more efficient structures.

Nevertheless, the Commission shares the concerns of many commenters responding to both the Fragmentation Release and the Proposing Release that improved disclosure alone might not prove sufficient to address all of the problems that can arise from substantial market fragmentation.[15] Accordingly, the Commission intends to monitor closely the effects of the disclosure rules on trading in the coming months. The Commission also plans to monitor the pending move to decimal trading in actively-traded equities, which potentially could address fragmentation concerns by enabling more vigorous competition on quoted price. After assessing the impact of the rules and decimals, it will consider whether additional action is necessary to address market fragmentation and further the Exchange Act's objectives for a national market system.

III. Rule 11Ac1–5—Disclosure of Order Execution Information

The Commission has decided to adopt Rule 11Ac1–5 substantially as it was proposed, subject to certain technical modifications. The Rule will require market centers to prepare and make available to the public monthly reports in electronic form that categorize their order executions and include statistical measures of execution quality. To facilitate comparisons across market centers, the Rule adopts basic measures of execution quality (such as effective spread, rate of price improvement and disimprovement, fill rates, and speed of execution) and sets forth specific instructions on how the measures are to be calculated. The statistical information will be categorized by individual security, by five types of order (*e.g.,* market and inside-the-quote limit), and four order sizes (*e.g.,* 100–499 shares and 500–1999 shares). As a result, users of the market center reports will have great flexibility in determining how to summarize and analyze statistical information. Users of the data will be able to analyze order executions for a particular security or for any particular group of securities, as well as for any size or type of orders across those groups of securities.

A. Comments on the Disclosure Approach of the Proposed Rule

The Commission received 51 comment letters on the disclosure of order execution practices reflected in the proposed rule.[16] A majority of letters were supportive of the objective of improved disclosure, although several expressed serious reservations regarding the implementation of this objective in the proposed rule. Those who supported the rule's approach noted the current lack of useful, public information with which to compare execution quality among market centers. They believed that the information required by the rule would help address this problem.[17] The Investment Company Institute, for example, noted that ''[c]urrently, it can be very difficult to obtain significant and meaningful data on the execution quality of market centers. In the absence of such data, it is difficult to compare execution quality across markets.'' Interactive Brokers believed that the rule ''will be a major step forward in improving investor awareness of the real costs they pay, both in time and money, for trade execution.'' Others noted that improved disclosure could benefit investors by acting as a spur to competition. Knight Trading Group believed that the proposed rules ''will serve to enhance investor protection and further competition for retail orders by enabling investors and their fiduciaries to evaluate more effectively the market centers to which their orders are routed.'' Salomon Smith Barney noted that ''an educated investor will force firms and market centers to compete vigorously with each other for customer order flow and improve the quality of executions and our capital markets.'' Marshall E. Blume stated that ''[t]hrough disclosure, investors will learn which markets provide better execution, and competition, not the SEC, will determine which markets will thrive.'' [18] Another commenter agreed, noting that ''transparency and disclosure are the foundation of fair competition.'' [19]

Although fully supporting the objective of improved disclosure of order execution practices, five commenters expressed reservations regarding the implementation of this objective in the proposed rule. Three suggested that the Commission should require much more detailed disclosure of individual orders and transactions, rather than the rule's approach of aggregating such data into statistical categories on a stock-by-stock basis.[20]

[15] *See, e.g.,* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 1 (''ICI Letter''); Letter from Robin Roger, Managing Director and Counsel, Morgan Stanley Dean Witter & Co., to Jonathan G. Katz, Secretary, SEC, dated Sept. 25, 2000, at 1 (''Morgan Stanley Letter''); Letter from Mary A. Burnes, Principal, OTC Trading, Edward D. Jones & Co., to Jonathan G. Katz, Secretary, SEC, dated Sept. 19, 2000, at 1 (''Edward Jones Letter''); Letter from Robert C. Gasser, Managing Director, J.P. Morgan Securities Inc., to Jonathan Katz, Secretary, SEC, dated Oct. 5, 2000, at 2 (''J.P. Morgan Letter'').

[16] The comment letters and a comprehensive summary of comments have been placed in Public File No. S7–16–00, which is available for inspection in the Commission's Public Reference Room.

[17] *See, e.g.,* ICI Letter, note 15 above, at 2; Letter from James E. Buck, Senior Vice President & Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated Oct. 17, 2000, at 1 (''NYSE Letter''); Letter from Thomas Peterffy, Chairman, and David M. Battan, Vice President and General Counsel, Interactive Brokers LLC, to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 2 (''Interactive Brokers Letter''); Letter from Michael T. Dorsey, Senior Vice President and General Counsel, Knight Trading Group, Inc., to Jonathan G. Katz, Secretary, SEC, dated Oct. 25, 2000, at 2 (''Knight Trading Letter''); Letter from William R. Harts, Managing Director, Salomon Smith Barney Inc., to Jonathan G. Katz, Secretary, SEC, dated Nov. 3, 2000, at 1 (''Salomon Smith Barney Letter''); Letter from Andrew A. Davis, Chairman and CEO, The Rock Island Company, and William R. Surman, Senior Vice President—Equity, Rock Island Securities, Inc., to Jonathan G. Katz, Secretary, SEC, dated Sept. 8, 2000, at 2 (''Rock Island Letter''); Letter from Alan R. Shapiro, President, and Howard Kohos, Executive Vice President, Transaction Auditing Group, Inc., to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 8 (''TAG Letter'').

[18] Letter from Marshall E. Blume, Howard Butcher III Professor of Financial Management, The Wharton School, University of Pennsylvania, to Jonathan G. Katz, Secretary, SEC, dated Sept. 7, 2000, at 1 (''Blume Letter'').

[19] Letter from Meng-yuan Wang, Executive Director of EMM, UBS Warburg, to Jonathan G. Katz, Secretary, SEC, dated Sept. 25, 2000, at 1.

[20] CSE Letter, note 13 above, at 9; Blume Letter, note 18 above, at 1; Letter from Cameron Smith, General Counsel, Island ECN, to Jonathan Katz, Secretary, SEC, dated Sept. 27, 2000, at 9 (''Island Letter''). The Proposing Release requested comment

Continued

Two other commenters expressed reservations about the usefulness of many statistical categories included in the proposed rule, and also noted the need for additional categories that were not included.[21]

The commenters that opposed the disclosure approach of the proposed rule did so for varying reasons. Five of the commenters were opposed to the approach primarily because they believed the Commission should address fragmentation by mandating a unified national linkage system with price/time priority.[22] The reasons identified by other commenters opposed to the disclosure approach can be divided into three major categories: (1) The proposed rule would over-emphasize quantitative factors, particularly execution price and speed, in obtaining best execution of investor orders; (2) the information on execution quality required by the proposed rule would be too complex and not very useful to investors; and (3) the statistical disclosures required by the proposed rule would greatly increase the risk of meritless private litigation. These issues are discussed below.

1. Emphasis on Execution Price and Speed

Many of the commenters opposing the disclosure approach of the proposed rule, as well those criticizing the rule's implementation of a disclosure approach, believed that it would over-emphasize the quantitative factors of execution price and speed in obtaining the best execution of investor orders.[23] The Commission agrees with these commenters that execution price and speed are not the sole relevant factors in obtaining best execution of investor orders. It repeatedly has noted that other factors may be relevant, such as (1) the size of the order, (2) the trading characteristics of the security involved, (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and (4) the cost and difficulty associated with achieving an execution in a particular market center. Rule 11Ac1–5 does not address, much less alter, the existing legal standards that apply to a broker-dealer's duty of best execution.

For example, the Commission previously has stated that a broker-dealer must regularly and rigorously evaluate the quality of execution it obtains for customers' orders.[24] This responsibility is not changed by Rule 11Ac1–5. Indeed, the monthly market center reports will encompass *all* the orders received by a market center from any number of different broker-dealers. In contrast, a broker-dealer is responsible only for the execution quality of its own customers' orders. If a market center's overall statistics do not reflect the quality of execution of the orders of the broker-dealer's customers, the broker-dealer appropriately should consider this disparity in meeting its duty of best execution. In sum, the rules adopted today do not define, either explicitly or implicitly, a broker-dealer's duty of best execution.

The Commission strongly believes, however, that most investors care a great deal about the quality of prices at which their orders are executed, and that an opportunity for more vigorous competition among market participants to provide the best quality of execution will enhance the efficiency of the national market system. Rule 11Ac1–5 is needed, not because price is the only important factor in routing orders, but because there currently is little or no public information that would allow investors to assess a broker-dealer's handling of its customer orders. For example, the Rule will allow investors to monitor the extent to which, in choosing execution venues, there are, in fact, systematic trade-offs that must be made between price and other factors, and the amount of those trade-offs. For example, if the best prices are consistently produced by one of the leading market centers with cutting-edge, highly-reliable trading systems, there would be little, if any, trade-off between price and systems reliability. Similarly, the rules will help customer weigh the trade-off between a market center that provided immediate executions at the quote, and a market center that executed orders on average in under 30 seconds, but that consistently generated prices resulting in average effective spreads that were a significant amount per share better than those paid by investors at other market centers. Currently, however, investors have little or no information that would allow them to evaluate how their broker-dealer has responded to such trade-offs. Rule 11Ac1–5 is intended to remedy this glaring absence of public information.

The Rule's disclosure of the average spreads at which investor orders are executed should not be construed as meaning that only price ''improvement''—defined as the execution of an order at a price better than the public quote at the time the market center received the order—is important. Price improvement is likely to be important to many small investors because small orders are the most likely, at least at some market centers, to receive significantly better prices than the public quotes. The Rule does not, however, focus solely on orders that receive price improvement. It requires the same types and degree of disclosure for orders that are executed at the quotes and at prices outside the quotes. Moreover, many commenters mistakenly believed that Rule 11Ac1–5 focused on price ''improvement'' to the exclusion of other important aspects of execution that relate to price, particularly the amount of liquidity available at different market centers. However, liquidity and price are integrally related. Liquidity reflects the extent to which larger size orders can be executed at prices that are equal to or not far away from the quotes when the order is submitted. To measure the amount of liquidity available at different market centers, Rule 11Ac1–5 requires separate disclosures concerning the extent to which orders are executed at prices better than the quotes, equal to the quotes, and outside the quotes. Each of these disclosures will be categorized by the following order sizes: 100–499, 500–1999, 2000–4999, and 5000 or more shares. Thus, these categories of information enable the comparison of the performance of market centers in

on disclosure of ''raw data'' as an alternative. The Commission is not adopting the alternative. If a market center believes, however, that the basic statistical measures included in the Rule do not adequately reflect the complexity of its order flow and execution quality, it also could make its raw data publicly available as a means to promote greater understanding of its performance.

[21] Letter from Mark B. Sutton, Chairman, Market Structure Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated Sept. 26, 2000, at 1 (''SIA Market Structure Committee Letter''; Letter from Lon Gorman, Vice Chairman, Charles Schwab & Co., to Jonathan G. Katz, Secretary, SEC, dated Sept. 28, 2000, at 1–2 (''Schwab Letter'').

[22] *See, e.g.,* Morgan Stanley Letter, note 15 above, at 1; Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business, to Jonathan G. Katz, Secretary, SEC, dated Sept. 6, 2000, at 3 (''Peake Letter'').

[23] *See, e.g.,* Pershing Letter, note 13 above, at 1 (''The Commission seems to be trying to create a quantitative definition of best execution.''); SIA Market Structure Committee Letter, note 21 above, at 3 (the proposed rules ''elevate price and speed over other, less easily quantifiable, measures that may be important to certain investors in assessing execution quality''); Schwab Letter, note 21 above, at 9 (''by focusing on price and speed, the Commission is explicitly endorsing these elements and implicitly indicating that all others are not relevant in the determination of best execution'').

[24] *See, e.g.,* Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (''Order Handling Rules Release''), at section III.C.2.

executing larger orders at prices equal to the public quotes. Moreover, one particular measure included in the Rule—the average effective spread—will capture the net effect of *all* executions in an order size. For example, a market center's average effective spread for market orders of 2000–4999 shares in a security will reflect the share-weighted average of the executions it provided for all of those orders. Thus, if a market center gave only a few orders price improvement, but executed most orders at prices outside the quotes, its average effective spread would be higher than the average effective spread reported by a market center that executed a high percentage of orders at prices equal to the public quotes.

The Commission also wishes to emphasize that Rule 11Ac1–5 is intended to establish a baseline level of disclosure that all market centers must meet in order to facilitate cross-market comparisons of execution quality. It does not preclude market centers from disclosing whatever additional information concerning their order execution practices that they believe would more fully convey the quality of their services.

2. Usefulness to Investors of Execution Quality Information

Commenters opposed to the proposed rule also questioned the usefulness to investors of the information on execution quality that would be included in the market center reports. In particular, they believed that the information was too complex for investors to understand, that the reports would overwhelm investors with statistical data, and that, as a result, investors would be vulnerable to being misled by those willing to ''spin'' the data to serve their own self interest.[25]

As an initial matter, the Commission disagrees with the notion that investors are incapable of understanding the fundamental principles of execution quality reflected in Rule 11Ac1–5.[26] Investors' current lack of *familiarity* with the statistical measures, rather than their inherent complexity, may contribute to an impression that the measures are complex. To date, very few market centers have made any public disclosures concerning their execution quality, such as their effective spread and rate of price improvement for different types of orders. The quoted spread, in contrast, has been widely disseminated pursuant to Commission rules and that is what investors have come to know. Given the enormous appetite of investors in recent years for better information about the markets (fueled largely by improved technology and lower communication costs), the Commission anticipates that many investors will come to appreciate the important distinction between quoted prices and the prices they actually receive. Nearly every statistical measure included in Rule 11Ac1–5, each of which is based on execution price and speed of execution, is straightforward in principle.

Commenters correctly observed, however, that a large volume of statistical data will be disclosed in the monthly execution quality reports. As discussed in the Proposing Release, the large volume of statistics reflects a deliberate decision by the Commission to avoid the dangers of overly-general statistics. Assigning a single ''execution quality'' score to market centers, for example, would hide major differences in execution quality, potentially creating far more problems that it solved. Instead, Rule 11Ac1–5, taking advantage of improved and more efficient information technology, requires electronic disclosure of basic order execution information that is categorized on a stock-by-stock basis. After this basic information is disclosed by all market centers in a uniform manner, market participants and other interested parties will be able to determine the most appropriate classes of stocks and orders to use in comparing execution quality across market centers.

Given the large volume of data that will be included in the reports, most individual investors likely would not obtain and digest the reports themselves.[27] The Commission anticipates that independent analysts, consultants, broker-dealers, the financial press, and market centers will analyze the information and produce summaries that respond to the needs of investors. Some commenters expressed discomfort with the varied and unstructured analysis that might arise once execution quality statistics become available to the public. However, many market participants will have an interest in clearly communicating to investors the salient information in ways that investors can understand. In time, investors should be able to assess the credibility of these analyses and use them in evaluating execution performance. Indeed, one of the most serious problems investors currently face with respect to choosing a broker is assessing the quality of order routing and execution services provided by various broker-dealers. After the rules adopted today become effective, competitive forces can be brought to bear on broker-dealers *both* with respect to the explicit trading costs associated with brokerage commissions and the implicit trading costs associated with execution quality. The Commission believes that investors ultimately will be the beneficiaries of this expanded competition.[28]

3. Risk of Meritless Litigation

Several commenters expressed concern that the required disclosures of order execution and routing practices would greatly increase the risk of private securities litigation alleging that broker-dealers failed to meet their duty of best execution.[29] The Commission

[25] *See, e.g.,* Morgan Stanley Letter, note 15 above, at 12–13; Pershing Letter, note 13 above, at 2; Letter from Robert H. Forney, President and Chief Executive Officer, Chicago Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 5, 2000, at 9 (''CHX Letter''); Letter from Lanny A. Schwartz, Executive Vice President and General Counsel, Philadelphia Stock Exchange, Inc., to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 1 (''Phlx Letter'').

[26] For example, the quoted spread and the effective spread are analogous to the manufacturer's suggested retail price (''MSRP'') for a product and the varying prices actually charged at different stores. The first reflects the price that might be charged; the second reflects the price actually charged, which could be better or worse than the first, and often is. The Commission similarly believes that investors, with proper explanation, can grasp the concept underlying average realized spread. This statistic is calculated by comparing the execution price of an order with the public quotes as they stand five minutes after the time of execution. As discussed further in section III.C.1 below, it measures the extent to which a market center receives order flow that is difficult to handle—either because it arrives during times when the markets are stressed or it comes from informed traders. It highlights those market centers that are willing to accept such difficult order flow, a praiseworthy quality that the Commission does not want the Rule's disclosure requirements to discourage.

[27] If interested, however, investors with access to the Internet and capable of using widely-available office application software could readily download and analyze a market center's monthly execution quality report. Private vendors also may offer services that enable individual investors to access and review market center reports.

[28] A commenter suggested that, without an independent verification requirement, some market centers might produce reports that were materially misleading. Morgan Stanley Letter, note 15 above, at 17. The Commission does not believe that an independent verification requirement is necessary at this time. Market centers subject to Rule 11Ac1–5 will be regulated entities that have met the integrity and competence standards of the Exchange Act. In addition, all market centers will be subject to inspection by the Commission. If registered as a broker-dealer, they also will be subject to inspection by their respective self-regulatory organizations (''SROs''). The Exchange Act grants the Commission and SROs ample enforcement powers to deal with any market center that makes materially misleading disclosures concerning its execution quality.

[29] SIA Market Structure Committee Letter, note 21 above, at 5; Letter from Bruce E. Coolidge of Wilmer, Cutler & Pickering, to Jonathan G. Katz, Secretary, SEC, dated Oct. 10, 2000; Letter from

Continued

expresses no opinion on some of the broader criticisms of private litigation made by these commenters. It is concerned, however, about comments that the required disclosures, particularly the detailed statistical information required by Rule 11Ac1–5, could be subject to misinterpretation that might pose a risk of *meritless* litigation. The Commission wishes to make clear its views as to the limits of these data in evaluating a broker-dealer's compliance with its legal duty of best execution. Both Rule 11Ac1–5 and Rule 11Ac1–6 are designed to require disclosure pursuant to Section 11A of the Exchange Act. They are not antifraud rules, nor do they create new duties under the antifraud provisions of the federal securities laws. The rules themselves create neither express nor implied private rights of action. Furthermore, Rule 11Ac1–5 and Rule 11Ac1–6 do not address and therefore do not change the existing legal standards that govern a broker-dealer's duty of best execution. The market center reports will provide statistical disclosures regarding certain of the factors relevant to a broker-dealer's order routing decision, but these factors alone are not determinative of whether the broker-dealer achieved best execution.

Rule 11Ac1–5 and Rule 11Ac1–6 are designed to generate uniform, general purpose statistics that will prompt more vigorous competition on execution quality. The information that will be generated as a result of these rules will not, by itself, be sufficient to support conclusions regarding a broker-dealer's compliance with its legal responsibility to obtain the best execution of customer orders. Any such conclusions would require a more in-depth analysis of the broker-dealer's order routing practices than will be available from the disclosures required by the rules.

For example, as discussed in section III.A.1 above, the execution quality statistics included in Rule 11Ac1–5 do not encompass every factor that may be relevant in determining whether a broker-dealer has obtained best execution. In addition, the statistics in a market center's reports typically will reflect orders received from a number of different routing broker-dealers. Legal conclusions about any one broker-dealer's routing practices require an assessment of additional information concerning how that broker-dealer's customer orders were executed. Moreover, under Rule 11Ac1–6, a broker-dealer's quarterly report will provide a general overview of its order routing practices. The information on where orders were routed during the quarter will be broken out only by the listing status of the security—NYSE, Nasdaq, Amex/other, and options. Within these categories, a broker-dealer may have varied its routing of different types of orders, or orders in different securities, so as to obtain results that would not be evident from the general statistics presented in the market center reports.

In sum, while the order execution and routing disclosures will represent a significant step forward in the quality of information that is currently publicly available, they alone will not provide a reliable basis to assess a broker-dealer's compliance with its duty of best execution. Therefore, the resulting statistics, by themselves, do not demonstrate whether or not broker-dealers have complied with their legal duties to their customers,[30] and to conclude otherwise would be contrary to the Commission's prior statements, discussed below, about the duty of best execution. Furthermore, the Commission believes that the possibility of multiple, inconsistent standards in interpreting this information in relation to various state law claims could tend to frustrate the statutory objective of establishing and monitoring the development of a national market system[31] and would undermine the Commission's effort to assure the practicability of brokers achieving best execution.[32]

The Commission previously has expressed three conclusions inconsistent with an overly-simplistic determination that a broker-dealer breached the duty of best execution. First, a broker-dealer is required to seek to obtain the most favorable *terms* reasonably available under the circumstances for a transaction (which may not in every case necessarily be the best price that might be available).[33] Second, the duty of best execution does not necessarily require broker-dealers with a large volume of orders to determine individually where to route each order. Third, a broker-dealer does not violate its best execution obligation solely because it receives payment for order flow or trades as principal with customer orders.[34]

To emphasize these points, we have added a ''Preliminary Note'' to Rule 11Ac1–5. It provides as follows:

> Section 240.11Ac1–5 requires market centers to make available standardized, monthly reports of statistical information concerning their order executions. This information is presented in accordance with uniform standards that are based on broad assumptions about order execution and routing practices. The information will provide a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed. The disclosures required by this Section do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. In addition, any particular market center's statistics will encompass varying types of orders routed by different broker-dealers on behalf of customers with a wide range of objectives. Accordingly, the statistical information required by this Section alone does not create a reliable basis to address whether any particular broker-dealer failed to obtain the most favorable terms reasonably available under the circumstances for customer orders.

The Commission believes that this clear statement will substantially address the danger of meritless litigation that might impose significant indirect costs on broker-dealers.

B. Scope of Rule

Paragraph (b)(1) of Rule 11Ac1–5 provides that every market center shall make available for each calendar month an electronic report on the covered orders in national market system securities that it received for execution from any person. Thus, the Rule is limited in scope to market centers, covered orders, and national market system securities.

1. Market Center

Paragraph (a)(14) of the Rule defines the term ''market center'' as any exchange market maker, OTC market maker, alternative trading system, national securities exchange,[35] or

---

Roger D. Blanc of Wilkie Farr & Gallagher, to Jonathan G. Katz, Secretary, SEC, dated Oct. 5, 2000, at 10 (''Wilkie Farr & Gallagher Letter''); Schwab Letter, note 21 above, at 13–17; Morgan Stanley Letter, note 15 above, at 17; Letter from the Regulatory Studies Program of the Mercatus Center at George Mason University, to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 14 (''Mercatus Center Letter''). *But see* Knight Trading Letter, note 17 above, at 12–14.

[30] For this reason, broker-dealers will be able to explain in their disclosures to customers the full range of factors that influenced their order routing decisions.

[31] Exchange Act Section 11A(a)(2). *See also Guice* v. *Charles Schwab & Co.,* 674 N.E.2d 282 (N.Y. 1996), *cert. denied,* 520 U.S. 1118 (1997).

[32] Exchange Act Section 11A(a)(1)(C)(iv).

[33] Similarly, the Commission has noted that ''in evaluating its procedures for handling limit orders, the broker-dealer must take into account any *material* differences in execution quality.'' Order Handling Rules Release, note 24 above, at section III.C.2 (emphasis added).

[34] *See id.* at section III.C.2.

[35] A national securities exchange is an exchange registered under Section 6 of the Exchange Act. An exchange exempted from registration pursuant to Section 5 of the Exchange Act therefore is not included within the Rule's definition of market center.

national securities association. This definition is intended to cover entities that hold themselves out as willing to accept and execute orders in national market system securities. In addition, the language in paragraph (b)(1) that a market center must report on orders that it ''received for execution from any person'' is intended to assign the disclosure obligation to the entity that is expected to control whether and when an order will be executed.[36]

The Commission anticipates that the reporting entity for the vast majority of orders will be an exchange specialist, OTC market maker, or ATS. Although specialists and market makers frequently operate under the auspices of an SRO (and such an SRO likely will greatly assist its members in meeting the disclosure requirements of the Rule),[37] the responsibility for executing orders generally is handled by the individual firms, and execution quality may vary significantly among them. This is particularly true where an exchange has multiple market makers in a security. It therefore is appropriate for the monthly reports to reflect these potential differences. In some cases, however, orders may be executed through a facility operated by an SRO without a member significantly controlling the order executions. Examples may include (1) the Small Order Execution System (''SOES'') operated by Nasdaq, and (2) floor brokers who receive orders on the floor of an exchange and obtain an execution of the orders with little participation by a specialist. The definition of market center includes exchanges and associations to cover these situations.[38]

2. Covered Order

The definition of ''covered order'' in paragraph (a)(8) of Rule 11Ac1–5 contains several conditions and exclusions that are intended to limit its scope to those orders that provide a basis for meaningful and comparable statistical measures of execution quality. First, the Rule applies only to market orders or limit orders that are received by a market center during regular trading hours and, if executed, executed during such time. The term ''regular trading hours'' is defined in paragraph (a)(19) of the Rule to mean between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to paragraph (b)(2) of the Rule. There are substantial differences in the nature of the market between regular trading hours and after-hours, and orders executed at these times should not be blended together in the same statistics.[39] In addition, covered orders must be received during the time that a consolidated BBO is being disseminated.[40] This restriction is necessary because nearly all of the statistical measures included in the Rule depend on the availability of a consolidated BBO at the time of order receipt. The term ''consolidated best bid and offer'' is defined in paragraph (a)(7) as the highest firm bid and the lowest firm offer for a security that is calculated and disseminated on a current and continuous basis pursuant to an effective national market system plan. The two plans that currently provide for the calculation and dissemination of a consolidated best bid and offer for national market system securities are the Consolidated Quotation Plan for listed equities and the Nasdaq/National Market System Plan for Nasdaq equities.[41]

The definition of covered order excludes any orders for which the customer requested special handling for execution and that, if not excluded, could skew general statistical measures of execution quality. Types of orders specifically excluded from the Rule include, but are not limited to, orders to be executed at a market opening or closing price, stop orders, orders such as short sales that must be executed on a particular tick or bid, orders submitted on a ''not held'' basis, orders for other than regular settlement, and orders to be executed at prices unrelated to the market price at the time of execution. All of these exclusions are retained from the proposed rule. In addition, the Rule as adopted now specifically excludes all-or-none orders on the basis that they often may be more difficult to execute than orders without a substantial minimum quantity requirement.[42]

Two types of orders warrant further discussion. The first type—immediate-or-cancel orders—is included in the Rule. The second—orders to be executed at a market opening price—is excluded for operational reasons, notwithstanding the significant issues of quality of disclosure for investors submitting these orders, particularly in Nasdaq securities.

a. Immediate-Or-Cancel Orders. The Commission has determined that ''immediate-or-cancel'' orders should be included in Rule 11Ac1–5. Immediate-or-cancel orders are immediately subject to execution under normal conditions. These orders are functionally nearly the same as orders that are submitted and cancelled almost immediately thereafter, which are included in the Rule. If not executed, they simply will be included in the statistic for a market center's cancelled orders under subparagraph (b)(1)(i)(C) of the Rule. Moreover, ECNs trading Nasdaq securities receive a substantial number of immediate-or-cancel orders, particularly those that are marketable limit orders. Thus, including these orders may be important to accurately assess the quality of these ECNs, and statistics that reflect the execution quality of these orders in ECNs may be of significant interest to investors.

b. Market Opening Orders. The Proposing Release requested comment on the appropriateness of excluding orders that are to be executed at a market opening price. Several commenters believed that such orders should be included in the Rule. Edward D. Jones & Co., for example, observed that approximately 10–20% of its order flow typically was executed at the opening and that it would be useful, particularly for Nasdaq securities, to segregate opening orders into a separate statistic. The Investment Company Institute stated that ''the quality of

[36] When a market center receives an order for execution, the order must be included in its statistical disclosures of execution quality even if the order is routed to another venue for execution. *See* section III.C.1 below.

[37] Indeed, the Commission anticipates that many SROs may, on behalf of their members, assume substantially all responsibility for complying with the Rule. Such an assumption of responsibility would be an acceptable way for an SRO and its members to meet the Rule's requirements.

[38] The Commission's staff will be available to provide interpretive guidance to market centers on how orders should be reported under the Rule.

[39] *See* Division of Market Regulation, SEC, Report on Electronic Communications Networks and After-Hours Trading (June 2000), at 29 (for the 15 largest capitalization stocks in the Nasdaq 100 index, average quoted spread, average effective spread, and trade price volatility increased significantly after the close of regular trading hours).

[40] The Proposing Release requested comment on orders received when the consolidated BBO is locked or crossed. One commenter suggested that such orders be excluded, as well as orders received during ''fast'' markets. TAG Letter, note 17 above, at 4. The adopted Rule continues to encompass such orders. Its statistical measures can all be calculated during periods when markets are locked, crossed, and fast. Moreover, one of the important characteristics of a market center is its ability to handle orders well during difficult market conditions.

[41] The full title of the Nasdaq Plan is ''Joint Self-Regulatory Plan Governing the Collection, Consolidation, and Dissemination of Quotation and Transaction Information for Exchange-Listed Nasdaq/National Market System Securities and for Nasdaq/National Market System Securities Traded on an Unlisted Trading Privilege Basis.''

[42] One commenter requested clarification concerning orders that are not sent to a market center for prompt execution, as are traditional market orders, or that are not priced orders. Letter from P. Mats Goebels, Senior Vice President & General Counsel, ITG, Inc., to Jonathan G. Katz, Secretary, SEC, dated Sept. 29, 2000, at 5. Such orders would not fall within the definition of ''covered order'' in subparagraph (a)(8), which applies only to market orders and limit orders.

execution of market opening orders in the Nasdaq market has been an issue of significant concern to market participants'' and that ''information on the quality of execution at the opening would assist market participants in determining how to trade securities at the opening of the market.''

The Commission fully shares the concerns of commenters over the need for improved information on the quality of execution of opening orders in Nasdaq securities. In this respect, the market for Nasdaq securities differs significantly from the market for exchange-listed securities, where the primary exchange generates and disseminates a single opening price. Moreover, it is the Commission's understanding that it is industry practice in the listed markets to provide investors with this single opening price for opening orders that are executed away from the primary exchange. In the market for Nasdaq securities, in contrast, it appears to be the common practice of many market centers to execute opening orders to buy at the quoted offer and opening orders to sell at the quoted bid, thereby charging a liquidity premium for a large volume of orders that effectively cross each other at a single point in time.

The Commission is aware that several important market centers trading Nasdaq securities have begun to offer services that give investors an opportunity to avoid paying a liquidity premium on opening orders. Such services can include, for example, ''mid-point pricing,'' pursuant to which both buy and sell orders are executed at the midpoint of the opening quoted bid and offer.[43]

The Commission is concerned that many investors may not be fully aware of the significant distinction between Nasdaq and listed securities with respect to the execution of opening orders. The Commission also is concerned that many investors may not be aware of the differing services offered by market centers for execution of opening orders in Nasdaq securities, and their impact on execution quality. Without question, including a separate category for opening orders in the Rule 11Ac1–5 statistics would highlight the differences in quality of execution of opening orders across market centers. Nevertheless, the Commission is reluctant to expand the quantity of the Rule's continuing and marketwide disclosure requirements to address an issue that is limited to a specific segment of the equities markets. Including additional statistics for opening orders in market center reports alone would increase the size of the reports by 20%. All market centers, both those trading listed and Nasdaq securities, would be required to include the opening order information, even though it would be nearly the same for all market centers offering a single price execution of these orders. In addition, Nasdaq is actively considering new opening procedures that could reduce disparities in execution quality.

Instead of substantially expanding the quantity of statistics required by the Rule to address this issue, the Commission believes that the markets and broker-dealers handling customer orders should be given a further opportunity to improve execution quality at the opening in Nasdaq securities. Market centers generally inform broker-dealers in advance how they will execute opening orders. Broker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders. Broker-dealers are encouraged to communicate clearly to customers the choices available for execution of opening orders, as well as the broker-dealer's policy for obtaining best execution of such orders. If necessary in the future, the Commission will consider requiring statistical disclosure of order execution quality at the opening.

3. National Market System Securities

Rule 11Ac1–5 applies only to securities that are designated as national market system securities under Exchange Act Rule 11Aa2–1. Currently, this designation applies to exchange-listed equities and equities included in the National Market tier of Nasdaq.[44] It does not apply to Nasdaq SmallCap securities, Over-the-Counter Bulletin Board securities, and exchange-listed options. SmallCap stocks tend to be inactively traded and, as a group, generate less than 5% of the dollar volume on Nasdaq while making up nearly 25% of Nasdaq companies.[45] Given the relatively light dollar amount of trading in these and Bulletin Board securities, the Commission believes at this time that the value of statistical measures of trading may not justify the costs to produce the information. After gaining experience with the Rule's operation, it will consider whether the scope of the Rule should be expanded.

The Proposing Release requested comment on whether Rule 11Ac1–5 should apply to orders for listed options. Interactive Brokers LLC strongly believed that the Rule should apply to options trading.[46] The Chicago Board Options Exchange (''CBOE''), in contrast, did not think that the Rule's disclosure approach was appropriate for options trading, although it did express support for the objective of improved disclosure in general.[47] The Commission continues to believe that there is a need for improved disclosure of execution quality in the options markets, particularly now that there is widespread trading of options on multiple exchanges and expanding payment for options order flow. Nevertheless, potentially difficult issues would have to be addressed before options could be included within Rule 11Ac1–5. For example, a consolidated BBO is not, at this time, calculated and disseminated for options trading. A consolidated BBO is an essential element for nearly every statistical measure in the Rule, such as calculating price improvement and classifying types of limit orders (*e.g.,* inside-the-quote and at-the-quote limit orders). Although each exchange potentially could calculate its own consolidated BBO, the calculations might vary at times and fail to provide a uniform basis for comparable statistics. In addition, categorization of orders on a security-by-security basis would be much less practical for the options markets, where there may be hundreds of series of options for one underlying security. The Commission's Office of Economic Analysis and OCIE currently are preparing a report on payment for order flow in the options markets. The report necessarily will address the quality of execution of options orders. After the report is completed, the Commission will consider whether additional action is needed to improve the quality of disclosure of execution quality in the options markets.

---

[43] The market centers that offer these improved prices for opening orders may, however, exclude them from their payment for order flow schedules, thereby potentially reducing the payments to broker-dealers that obtain these better prices for their customers.

[44] Rule 11Aa2–1 incorporates the definition of ''reported security'' that is used in Exchange Act Rule 11Aa3–1—any security for which transaction reports are made available pursuant to a reporting plan approved under Rule 11Aa3–1. Only exchange-listed equities and Nasdaq National Market equities currently fall within this definition.

[45] *See* NASD Economic Research Dept., *http://www.marketdata.nasdaq.com* (visited June 27, 2000).

[46] Interactive Brokers Letter, Note 17 above, at 4.

[47] Letter from Thomas A. Bond, Chicago Board Options Exchange, to Jonathan G. Katz, Secretary, SEC, dated Oct. 9, 2000 at 3 (''CBOE Letter'').

C. Required Information

Paragraph (b)(1) of Rule 11Ac1–5 requires market center reports to be categorized by individual security, order type, and order size. These categories are defined in paragraphs (a)(4) through (a)(6) of the Rule. The five types of orders are market, marketable limit, inside-the-quote limit, at-the-quote limit, and near-the-quote limit. The four buckets of order size are 100–499, 500–1999, 2000–4999, and 5000 or more shares. With this degree of categorization, a market center will, for example, produce statistical information for the subcategory of market orders for 100–499 shares in an individual stock.

Several commenters criticized the categories specified in the proposed rule.[48] The Commission has decided to retain the categories at this time, although experience with the Rule may indicate ways in which they could be improved in the future. The categories are intended to strike a balance between (1) sufficient aggregation of orders to produce statistics that are meaningful, and (2) sufficient differentiation of orders to facilitate fair comparisons of execution quality across market centers. If a market center believes that the categories do not fully reflect its order flow and execution practices, it is encouraged to make any additional information publicly available that it believes would be helpful to investors.

1. Information Required for All Types of Orders

For each subcategory of security/order type/order size, paragraph (b)(1)(i) specifies eleven columns of information that must be provided. The first five columns provide general information on the orders received by a market center in a subcategory and the disposition of those orders. The first column is ''the number of covered orders.'' The second, however, is ''the cumulative number of shares of covered orders'; and thereafter all statistics required by the Rule are expressed either in number of shares or in share-weighted amounts. The Rule uses share-based statistics primarily to deal with those situations in which a single order receives less than a full execution or more than one partial execution.

The Rule requires disclosure of the number of shares cancelled prior to execution,[49] and the number of shares executed at both the receiving market center and at any other venue (after being routed elsewhere by the receiving market center). Thereafter, all statistical measures of order execution for a market center will encompass *both* orders that were executed at the receiving market center and orders that were executed elsewhere. In calculating its statistics, a market center will use the time it received the order and the consolidated BBO at the time it received the order, not the time and consolidated BBO when the venue to which an order was forwarded received the order. The Commission believes that a market center should be held accountable for all orders that it receives for execution and should not be given an opportunity to exclude difficult orders from its statistical measures of execution quality by routing them to other venues. In addition, from the perspective of the customer who submitted the order, the fact that a market center chooses to route the order elsewhere does not reduce the customer's interest in a fast execution that reflects the consolidated BBO as close to the time of order submission as possible. Consequently, in evaluating the quality of order routing and execution services, it is important for customers to know how a market center handles all orders that it receives, not just those it chooses to execute.

The term ''time of order receipt'' is defined in paragraph (a)(21) of the Rule as the time (to the second) that an order was received by a market center for execution. The definition is intended to identify the time that an order reaches the control of the market center that is expected, at least initially, to execute the order. In many cases, a broker-dealer may receive an order from a customer in a security for which the broker-dealer also is an OTC market maker or an exchange specialist. In such cases, the market center will be considered to have received an order for execution only when the order is transmitted to the department of the firm responsible for making a market in the security.

A commenter noted the danger that a market center might attempt to manipulate the time of receipt for its order flow. It stated, for example, that ''a market maker executing captive market orders pursuant to an internalization or payment for order flow arrangement who has agreed to ''step up and match'' the NBBO can create for itself a free option by monitoring market movements before and/or after receipt of any order and assigning as an execution price for that order whatever ''NBBO'' is most favorable to the market maker during the brief option period.'' [50] The Commission agrees that it is critically important for market centers to assign a time of receipt (including seconds) to orders in a prompt, consistent, and non-manipulatory manner. The Commission's inspections of market centers will include a review for compliance with this standard, and failure to meet the standard would be a serious violation of the Rule.

The next five columns required by paragraph (b)(1)(i) of the Rule ask for the number of shares that were executed within specified periods of time after order receipt (such as ''from 0 to 9 seconds'' and ''from 10 to 29 seconds''). Although required for all types of orders, the Commission anticipates that this information will be most useful for evaluating the execution of non-marketable limit orders. These statistics are intended to provide useful comparisons to the overall fill rates for non-marketable limit orders.[51] Particularly for inside-the-quote and at-the-quote limit orders, the submitter of the order reasonably may expect that the order should be executed relatively quickly, and information on the likelihood that such an order will be executed with 10 seconds, 30 seconds, and so on, at different market centers may be helpful in guiding the order routing decision.

The final column of information required for all types of orders is the average realized spread. The term ''average realized spread'' is defined in paragraph (a)(3) of the Rule and is calculated by comparing the execution price of an order with the midpoint of the consolidated BBO as it stands five minutes after the time of order

[48] Phlx Letter, note 25 above, at 4; CSE Letter, note 13 above, at 6–7; Schwab Letter, note 21 above, at 10–11.

[49] A commenter suggested that the Rule should exclude cancelled orders in calculations of execution quality measures. Letter from Richard G. Ketchum, National Association of Securities Dealers, Inc., to Jonathan G. Katz, Secretary, SEC, dated Oct. 17, 2000, at 3. In fact, the Rule does not specify whether cancelled orders should or should not be included in calculating measures such as price improvement rates for market orders and fill rates for limit orders. Instead, market centers will disclose the number of cancelled shares, and analysts are free to use or exclude cancelled orders in performing their calculations as they think most appropriate.

[50] Interactive Brokers Letter, note 17 above, at 3–4.

[51] The overall fill rates for such orders can be calculated by comparing the number of shares executed with the total number of shares received. Such overall fill rates for non-marketable limit orders can be difficult to interpret because of the problem of cancelled orders. An aggressive user of non-marketable limit orders frequently will submit orders with limit prices at or inside the current consolidated BBO. If market prices move away from the order, the order submitter may cancel and resubmit the order at a new limit price that reflects the changing consolidated BBO. Consequently, the same person potentially may cancel and resubmit an order several times to maintain the aggressiveness of the limit price. These cancellations can make it difficult to evaluate overall fill rates and cancellation rates.

execution.[52] The smaller the average realized spread, the more market prices have moved adversely to the market center's liquidity providers after the order was executed, which shrinks the spread ''realized'' by the liquidity providers. In other words, a low average realized spread indicates that the market center was providing liquidity even though prices were moving against it for reasons such as news or market volatility.

Many commenters questioned the usefulness of this statistic and recommended that it be eliminated.[53] The Commission believes, however, that the average realized spread is an essential measure for evaluating a market center's order execution practices and so we have retained the measure in the Rule. Most importantly, marketwide disclosure of realized spreads will help address a potentially serious incentive problem that could arise during ''stressed'' markets (*i.e.,* when prices are moving quickly). A market center of ''last resort''—one that executes a greater proportion of orders when the market is stressed—generally will post wider effective spreads during those periods, even though the realized spread may remain quite low or negative (because prices are moving rapidly against those providing liquidity during the stressed period). Thus, marketwide disclosure of realized spreads can help identify those market centers willing to supply liquidity during difficult times. If average realized spread were not included in the Rule, it might create an incentive for market centers to avoid trading in times of stress, leading to a drop in liquidity at the very time when it is most needed.

In addition, for market orders (as well as marketable limit orders), average realized spread can measure the extent to which ''informed'' and ''uninformed'' orders are routed to different market centers. Informed orders are those submitted by persons with better information than is generally available in the market. They therefore represent a substantial risk to liquidity providers that take the other side of these informed trades. In contrast, orders submitted by persons without an information advantage (often small orders) present less risk to liquidity providers and in theory should receive the most favorable effective spreads available in the market. Market centers may attempt to identify and secure a substantial flow of uninformed orders, while avoiding, and perhaps even rejecting, informed orders. The average realized spread statistic for market and marketable limit orders can highlight the extent to which market centers receive uninformed orders (as indicated by higher realized spreads than other market centers), thereby potentially helping to spur more vigorous competition to provide the best prices to these orders to the benefit of many retail investors. Other market centers, for example, may seek to obtain such profitable order flow by offering to execute the orders at narrower effective spreads (which also would result in narrower realized spreads for these orders).

Finally, average realized spread can generate useful information for non-marketable limit orders. The most significant risk of using such orders is that they will not be executed and will miss the market. The likelihood of execution can vary depending on the extent to which traders that are able to see all the orders (such as specialists, floor traders, and OTC market makers) are able to step in front of displayed limit orders by improving on the limit price as market orders arrive on the other side of the market. This can lead to another type of trading cost for limit orders that is commonly referred to as ''adverse selection''—the greater likelihood that limit orders will be executed when the market is moving significantly against them. The frequency with which local traders step in front of limit orders can heighten the cost of adverse selection for limit order investors. This ''last mover'' advantage for local trading interest can be substantial, and the average realized spread can indicate the extent to which it affects the execution costs of limit orders.[54]

For market centers that comply with Rule 11Ac1–5 by comparing their order data with a record of the consolidated quote stream (the method commonly used today to prepare analyses of execution quality), calculating the statistic is not significantly more burdensome than calculating the Rule's other statistics. As with effective spread (discussed below), execution prices are compared with a record of the consolidated quote stream. Effective spread is calculated using the quotes at the time of order receipt; realized spread is calculated using the quotes five minutes after the time of order execution.

2. Information Required for Market and Marketable Limit Orders

Subparagraph (b)(1)(ii) of Rule 11Ac1–5 specifies an additional nine columns of information for subcategories of market orders and marketable limit orders. These columns are intended to help evaluate how well these orders are executed by comparing their execution prices with the consolidated BBO at the time of order receipt. The time of order receipt is used rather than the time of order execution primarily based on an understanding that customers, at least for purposes of evaluating execution quality, generally expect orders to be executed at prices that reflect, as closely as possible, the displayed quotes at the time they submit their orders. The earliest time at which a market center can be held responsible for executing an order is the time of receipt.

The first of these columns is the average ''effective'' spread (in contrast to the average ''realized'' spread that was discussed above). Average effective spread is defined in paragraph (a)(2) of the Rule and is calculated by comparing the execution price of an order with the midpoint of the consolidated BBO at the time of order receipt. The larger the effective spread, the higher the transaction costs for market and marketable limit orders in that security. The average effective spread is a comprehensive statistic that summarizes the extent to which market and marketable limit orders are given price improvement, executed at the quotes, and executed outside the quotes. As such, it is a useful single measure of the overall liquidity premium paid by those submitting market and marketable limit orders to a market center.

The final eight columns of information required for market and marketable limit orders essentially break out the major determinants of execution quality that are summarized in the average effective spread. They also are intended to provide a substantial basis to weigh any potential trade-offs between execution speed and execution price. Orders are classified based on whether they were ''executed with price improvement,'' ''executed at the quote,'' or ''executed outside the quote,'' as defined in paragraphs (a)(10) through (a)(12). For shares executed with price

[52] The proposed rule incorporated a 30-minute time period for calculating average realized spread. Several commenters suggested that, given the volatility of stock prices, five minutes would be a more appropriate time period and would generate more useful information. ICI Letter, note 15 above, at 4; Rock Island Letter, note 17 above, at 2. The Commission agrees and has incorporated a five-minute time period in the Rule as adopted.

[53] *See, e.g.,* NYSE Letter, note 17 above, at 9–10; NASD Letter, note 49 above, at 4–5; SIA Market Structure Committee Letter, note 21 above, at 4.

[54] For example, if local traders at a particular market center display a great deal of expertise in deciding when to step ahead of displayed limit orders, the average realized spread for those limit orders would be comparatively high (they would almost always be executed only when the market was moving significantly against them).

improvement and shares executed outside the quote, market centers will disclose the number of shares, the average amount per share of price improvement or price disimprovement, and the average speed of execution. For shares executed at the quote, market centers will disclose the number of shares and the average speed of execution. Not only will these statistics help broker-dealers and investors evaluate where to find the fastest executions at the best prices, they also will indicate the extent to which market centers are able to execute larger orders at prices equal to or better than the quotes. They thereby indicate the volume of liquidity available at different market centers.

Many commenters suggested including an additional statistic for ''size improvement'' or ''liquidity enhancement'' in the Rule. These measures generally are calculated by comparing the size of order executions at the quotes with the size associated with the consolidated BBO at the time of order receipt. The Commission did not add this type of measure to the Rule, primarily because of its desire to minimize as much as possible the complexity and quantity of statistics to be disclosed. As discussed in section III.A.1 above, Rule 11Ac1–5 already includes several measures that will reflect the extent to which a market center is able to execute larger orders at prices equal to the public quotes, such as the average effective spread and number of shares executed at the quotes for larger sizes of orders. Moreover, the size associated with the consolidated BBO may not provide a useful basis on which to compare execution quality among market centers. For example, consolidated size varies substantially between Nasdaq and listed securities. For listed securities, the quoted size nearly always reflects the quotes of the primary exchanges and generally is much larger than the size associated with the public quotes for Nasdaq securities.

The Proposing Release requested comment on the usefulness of all the basic measures of execution quality included in the proposed rule, as well as on any alternative measures that commenters might suggest. For non-marketable limit orders, the Proposing Release specifically mentioned (1) the length of time that an order remained on a market center's order book while the limit price was at the consolidated BBO or better, and (2) the number of trades or share volume printed on the consolidated tape at prices equal to or less favorable than the limit order price. Several commenters expressed support for including these alternatives in the Rule.[55] In addition, commenters suggested many other statistical measures of execution quality that could be included.[56] At this time, however, the Commission has decided not to expand the volume of statistics required by the Rule. Many of the suggested alternatives would have substantially increased the complexity of the Rule. For simplicity reasons, the Commission therefore has retained the basic measures that were included in the proposal. Market centers are encouraged, however, to make publicly available any additional measures of execution quality that they believe will be helpful to broker-dealers and investors, particularly if they are concerned that the Rule's basic measures do not adequately capture the complexity of their order flow and executions.

D. Procedures for Making Reports Available to the Public

In light of the large volume of data the monthly order execution reports necessarily will include, they must be made available by market centers in electronic form rather than in writing. Consequently, paragraph (b)(2) of Rule 11Ac1–5 directs the SROs to act jointly in establishing procedures for market centers to follow in making their monthly reports available to the public in a readily accessible, uniform, and usable electronic format.[57] Given that the reports will be made available each month by a large number of market centers, the Commission's primary concern is that interested parties have the ability to access the reports easily and efficiently. Thus, for example, it will be helpful for all the reports to be prepared in a compatible electronic format, and for users to have ready access to the locations where reports can be obtained. The volume of data included in the monthly reports, while large in written form, will not be large when compared with many electronic files commonly made available to the public over the Internet.

Rule 11Ac1–5 will be effective 60 days after publication of this release in the **Federal Register**. Market centers must comply with the Rule according to the phase-in schedule set forth in section V below. The SROs are directed to prepare and submit a joint national market system plan to the Commission for approval under Exchange Act Rule 11Aa3–2 by no later than February 15, 2001. At that point, public comment will be invited on the proposed plan prior to Commission approval. Many of the more detailed issues relating both to the format of the reports and to the means of access to the reports can perhaps more appropriately be addressed in the context of approval of a joint plan.

In the event that a joint-SRO plan has not been approved by the Commission prior to the compliance date of the Rule, paragraph (b)(2) also provides that market centers shall prepare their reports in a consistent, usable, and machine-readable electronic format, and make such reports available for downloading from an Internet web site that is free and readily accessible to the public. This backstop requirement will assure that valuable information on order execution quality will be made available to the public without undue delay. If necessary, the Commission will take additional action to specify in more detail a uniform format and means of dissemination for the monthly market center reports.

Paragraph (b)(3) of Rule 11Ac1–5 requires market centers to make their reports available within one month after the end of the month addressed in the report. Market centers must make their reports available without charge. If a market center believes that its particular circumstances warrant an exemption from the provisions of the Rule, it may request an unconditional or conditional exemption pursuant to paragraph (c) of the Rule, which has been added to the proposed rule. Such an exemption will be granted if the Commission finds that it is necessary or appropriate in the public interest, and is consistent with the protection of investors.

IV. Rule 11Ac1–6—Disclosure of Order Routing Information

The Commission is adopting Rule 11Ac1–6 with significant changes from the proposed rule. Primarily in response to concerns of commenters, it has substantially cut back the amount of information that broker-dealers will be required to disclose concerning their order routing practices. The majority of commenters supported disclosures that would enable investors to better understand where orders are routed for execution and the relationships between

[55] *See, e.g.,* TAG Letter, note 17 above, at 5; Edward Jones Letter, note 15 above, at 3.

[56] *See, e.g.,* NASD Letter, note 49 above, at 5; Schwab Letter, note 21 above, at 9–10.

[57] Section 11A(a)(3)(B) of the Exchange Act authorizes the Commission, by rule or order, to require SROs to act jointly with respect to matters as to which they share authority in planning, developing, operating, or regulating the national market system.

broker-dealers and trading venues.[58] Several, however, expressed concern about the length and usefulness of some of the disclosure requirements included in the proposed rule.[59] In addition, a number of other commenters generally questioned the value of the required disclosures.[60] As discussed in section II above, the Commission believes that quarterly reports identifying the venues to which broker-dealers routed their customer orders and discussing potential conflicts of interest will be useful to investors. To maintain the brevity and reduce the compliance burdens of the reports, it has decided to delete several provisions from the proposed rule that would have required potentially long and complex explanations of order routing choices of broker-dealers.

Under Rule 11Ac1–6 as adopted, a broker-dealer that routes orders on behalf of customers will be required to prepare quarterly reports that disclose the identity of the venues to which it routed orders for execution. The reports also will disclose the nature of the broker-dealer's relationship with those venues, including the existence of any internalization or payment for order flow arrangements. Finally, broker-dealers will be required to disclose, on customer request, where they routed a customer's individual orders for execution.

In a significant change from the rule as proposed, a broker-dealer will not be required to prepare a narrative section for the reports that discusses and analyzes its order routing practices. The Commission agrees with commenters that such a requirement could result in reports that were overly long and complex. In addition, a broker-dealer will not be required to identify every venue to which it routed any orders. Instead, only the most significant venues—the top ten and any others that received 5% or more of the broker-dealer's orders—must be disclosed. The primary purpose of the Rule as adopted is simply to assure public disclosure of the significant venues to which a broker-dealer routes its customer's orders and to facilitate an evaluation of potential conflicts of interest between the broker-dealer and its customers. When combined with the information to be made available by market centers under Rule 11Ac1–5, the quarterly reports should provide a much clearer picture of a broker-dealer's order routing practices than has previously been available to the public.

A. Scope of Rule

The scope of Rule 11Ac1–6 is broader than the scope of proposed Rule 11Ac1–5. First, Rule 11Ac1–6 covers a wider range of securities. The definition of ''covered security'' in paragraph (a)(1) includes not only national market system securities (*i.e.,* exchange-listed equities and Nasdaq National Market equities), but also Nasdaq SmallCap equities and listed options.[61] Second, the Rule applies to all broker-dealers that route orders on behalf of their customers. The term ''customer order'' is defined as any order to buy or sell a covered security that is not for the account of a broker-dealer. It excludes, however, any order for a quantity of a security having a market value of at least $50,000 for a covered security that is an option contract and a market value of at least $200,000 for any other covered security. Large orders are excluded in recognition of the fact that a general overview of order routing practices is more useful for smaller orders that tend to be homogenous.[62]

Finally, Rule 11Ac1–6 applies to all types of orders (*e.g.*, pre-opening orders and short sale orders), but broker-dealers must give an overview of their routing practices only for ''non-directed orders.'' Paragraph (a)(5) defines a non-directed order as any customer order other than a directed order. Paragraph (a)(3) defines a directed order as a customer order that the customer specifically instructs the broker-dealer to route to a particular venue for execution. Consequently, all customer orders are non-directed orders in the absence of specific customer instructions on where they are to be routed.

B. Quarterly Reports

Paragraph (b)(1) of the Rule 11Ac1–6 requires broker-dealers to make publicly available for each calendar quarter a report on its routing of non-directed orders in covered securities. The term ''make publicly available'' is defined to require broker-dealers to do three steps—post on a free Internet web site, furnish a written copy on request, and notify customers at least annually that a written copy will be furnished on request. The Commission expects that the broker-dealer quarterly reports on order routing will be of direct interest to investors, and so is requiring that broker-dealers make them readily available via the Internet. In addition, a primarily Internet method of dissemination will ease the burden of compliance on broker-dealers by reducing paperwork and costs. The reports must be provided on request for customers that may lack Internet access.

Paragraph (b)(2) requires that a quarterly report be made publicly available within one month after the end of the quarter addressed in the report. A longer two-month period was included in the proposed rule to allow broker-dealers an opportunity to evaluate the monthly market center reports under Rule 11Ac1–5 prior to preparing their narrative discussion and analysis of order routing practices. Because this narrative disclosure has been eliminated from the Rule as adopted, the lag-period between end-of-quarter and report dissemination has been shortened to one month to provide more timely disclosures to the public.

Rule 11Ac1–6 as adopted requires that a quarterly report be divided into four separate sections for four different types of covered securities—one for equity securities listed on the NYSE, one for equity securities qualified for inclusion in Nasdaq, one for equity securities listed on the Amex or any other national securities exchange, and one for options. These sections reflect potentially significant differences in routing practices for the four types of securities and should enhance the usefulness of the quarterly reports to investors. For each of these four sections, paragraphs (b)(1)(i) and (ii) of the Rule require broker-dealers to give a quantitative description of the *aggregate* nature of their order flow. In this

[58] *See, e.g.,* Letter from Edward J. Nicoll, Chairman and CEO, Datek Online Holdings Corp., to Jonathan G. Katz, Secretary, SEC, dated Sept. 25, 2000, at 1 (''Datek Letter''); Letter from James H. Lee, President Momentum Securities, LLC, to Jonathan G. Katz, Secretary, SEC, dated Oct. 11, 2000, at 5; ICI Letter, note 15 above, at 5.

[59] NASD Letter, note 49 above, at 4; CHX Letter, note 25 above, at 11; Edward Jones Letter, note 15 above, at 4.

[60] Morgan Stanley Letter, note 15 above, at 15; Schwab Letter, note 21 above, at 3–4; Wilkie Farr & Gallagher Letter, note 29 above, at 3.

[61] To include Nasdaq SmallCap equities, paragraph (a)(1)(i) of Rule 11Ac1–6 incorporates the language of current Rule 11Ac1–1(a)(1)—''any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act.'' This language covers SmallCap equities, but excludes equities quoted on the OTC Bulletin Board operated by the NASD. To include option securities, paragraph (a)(1)(ii) of the Rule includes ''any option contract traded on a national securities exchange for which last sale reports and quotation information are made available pursuant to a national market system plan.'' This language includes any option securities for which market information is disseminated on a real-time basis pursuant to the national market system plan administered by the Options Price Reporting Authority (''OPRA'').

[62] In addition, a new paragraph (d) has been included in the Rule explicitly providing that the Commission may exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of Rule 11Ac1–6. Such an exemption will be granted if the Commission determines that it is necessary or appropriate in the public interest, and is consistent with the protection of investors.

respect, Rule 11Ac1–6 is unlike Rule 11Ac1–5, which requires market centers to categorize their orders on a security-by-security basis. As noted above, the quarterly reports on order routing are intended to provide a general overview of a broker-dealer's practices that is accessible and useful to individual investors. Broker-dealers are free, however, to disclose any additional information concerning their order routing practices that they believe will be helpful to customers.

A broker-dealer's quantitative description of order routing must include the percentage of total customer orders for a particular section that were non-directed orders, and the percentages of total non-directed orders for a section that were market orders, limit orders, and other orders. This general description of a broker-dealer's order flow should facilitate customer understanding of its routing practices. For example, a customer may use the reports to evaluate whether the broker-dealer specializes in the type of orders that the customer typically uses. The quantitative description also will include the identity of the ten venues to which the largest number of non-directed orders for the section were routed for execution, as well as any venue to which five percent or more of non-directed orders were routed.[63] In contrast, the proposed rule would have required disclosure of all venues to which non-directed orders were routed. A commenter noted that large broker-dealers may route a relatively small number of orders to many different venues.[64] Disclosure therefore has been limited to the most significant venues.[65]

For each of the venues identified in each section of the report, the broker-dealer must disclose the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, non-directed limit orders, and non-directed other orders for the section that were routed to the venue. The percentages, rather than numbers, of orders are used to facilitate customer understanding of the probability that particular types of orders will be routed to different venues without the need for calculations, as well as to protect potentially sensitive order flow information.

Under paragraph (b)(1)(iii), a broker-dealer also will be required to discuss the material aspects of its relationship with each venue identified in each section of the report, including a description of any payment for order flow arrangement or profit-sharing relationship as it relates to the type of securities for that section. The term ''payment for order flow'' is defined very broadly in Exchange Act Rule 10b–10(d)(9) to include any payment or benefit that results in compensation to the broker-dealer for routing orders to a particular venue. This definition encompasses a wide range of practices in addition to monetary payments, such as ''research, clearing, custody, products or services,'' ''reciprocal agreements for the provision of order flow,'' and ''discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation.'' The term ''profit-sharing relationship'' is defined in paragraph (a)(7) of Rule 11Ac1–5 to mean any ownership or other type of affiliation under which the broker-dealer, directly or indirectly, shares in any profits that may be derived from the execution of non-directed orders. It therefore specifically covers internalization of customer orders by a broker-dealer that executes customer orders as principal.

The purpose of requiring disclosure concerning the relationships between a broker-dealer and the venues to which it routes orders is to alert customers to potential conflicts of interest that may influence the broker-dealer's order-routing practices. Currently, Rule 10b–10(a)(2)(i)(C) requires a broker-dealer, when acting as agent for the customer, to disclose on the confirmation of a transaction whether payment for order flow was received and that the source and nature of the compensation for the transaction will be furnished on written request. In addition, Exchange Act Rule 11Ac1–3(a) requires broker-dealers to disclose in new and annual account statements its policies on the receipt of payment for order flow and its policies for routing orders that are subject to payment for order flow. The Commission believes that disclosure of potential conflicts of interest *in conjunction with* a quantitative description of where all non-directed orders are routed may provide customers with a clearer understanding of a broker-dealer's order routing practices than is provided under current rules. The Commission intends to consider in the near future whether to modify or rescind, as necessary, the disclosure requirements currently in effect concerning payment for order flow, in light of the new quarterly disclosure requirements.

Rule 11Ac1–6 does not require that broker-dealers provide a quantitative estimate of the *aggregate* dollar amount of payment for order flow received during a quarter from each order execution venue. First, there are potentially a multitude of varying arrangements for payment for order flow. Estimating the amounts produced by such arrangements could be difficult, subjective, and costly. Second, the Commission is concerned that disclosure of the aggregate dollar amounts of payment for order flow, without requiring comparable disclosure of the dollar amount of trading profits that redound to the benefit of broker-dealers pursuant to profit-sharing relationships, potentially could paint an inaccurate picture of the relative financial incentives generated by the two types of relationships.

Although the Rule 11Ac1–6 does not require an estimate of the aggregate dollar amount of payment for order flow, a broker's description of a payment for order flow arrangement must include disclosure of the material aspects of the arrangement. These would include a description of the terms of the arrangement, such as any amounts per share or per order that the broker receives. Similarly, in describing a profit-sharing relationship, a broker would be expected to disclose the extent to which it could share in profits derived from the execution of non-directed orders. An example would be the extent of the ownership relation

[63] The term ''venue'' is intended to be interpreted broadly to cover ''market centers'' within the meaning of Rule 11Ac1–5(a)(14), as well as any other person or entity to which a broker routes non-directed orders *for execution.* Consequently, the term excludes an entity that is used merely as a vehicle to route an order to a venue selected by the broker-dealer. Interpretive issues may arise in determining the applicability of the Rule when a person or entity trades under the auspices of an exchange. To assure meaningful disclosure of significant execution venues, all orders routed to a particular exchange for execution should be aggregated when calculating a broker-dealer's top ten market centers and those with 5% of orders. If a particular market maker or dealer at the exchange receives orders pursuant to any arrangement that gives it a preference to trade with the order as principal, such arrangement must be specifically included in the discussion of the relationship between broker-dealer and venue that is required by Rule 11Ac1–6(b)(1)(iii).

[64] Schwab Letter, note 21 above, at 5.

[65] Interpretive issues could arise in the case of an order that is routed to multiple venues *by the broker-dealer* (if an execution venue alone makes the decision to forward an order to a second venue, the second venue generally would not be included in a broker-dealer's report). If an order is executed after being routed by the broker-dealer to multiple venues, the venue that executed the order should be considered the venue to which the order was routed for purposes of the Rule. If an order is *not* executed after being routed to multiple venues (*e.g.,* it was cancelled or expired), the first venue should be considered the venue to which the order was routed for purposes of the Rule. The Commission's staff will be available to provide further interpretive guidance on compliance with the Rule.

between the broker and execution venue.

Finally, as noted above, the Rule as adopted does not include a requirement that broker-dealers provide a narrative discussion and analysis of their order routing practices. Broker-dealers remain free, of course, to communicate such information concerning their order routing practices that they believe would be helpful to customers.

C. Customer Requests for Information

A broker-dealer's quarterly reports should provide a useful picture of its order routing practices as a whole, but will not inform individual customers where their own orders were routed. Currently, there is no market-wide requirement that brokers disclose where they route individual orders on behalf of customers. Although NYSE Rule 409(f) requires NYSE members, when confirming transactions, to disclose ''the name of the securities market on which the transaction was made,'' transactions executed at venues other than exchanges typically are classified as ''OTC.'' Thus, the identity of the particular OTC market maker or ATS that executed an order is not required to be disclosed. Moreover, the NYSE's rule does not cover non-members or securities that are not listed on the NYSE.

To assure that customers have ready access to routing information concerning their own orders, paragraph (c) of Rule 11Ac1–6 requires broker-dealers, on request of a customer, to disclose to the customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.[66] To alert customers to the availability of individual order routing information, paragraph (c)(2) of the Rule requires broker-dealers to notify their customers at least annually of their option to request such information.

With Rule 11Ac1–6, those customers interested in monitoring the broker-dealer's routing their orders will be entitled to learn important information about how their orders were handled. When combined with information that such customers may already maintain, such as the time they submitted an order to their broker-dealer, the consolidated BBO at the time they submitted the order, and the price at which an order was executed, the information to be provided on request potentially could give customers a considerable capacity to monitor and evaluate their broker-dealer's order routing decisions and the quality of executions obtained at different venues. Broker-dealers would not, however, be required to bear the expense of providing individualized order routing information to those who had not asked to receive it.

V. Effective Dates and Phase-In of Compliance Dates

Rule 11Ac1–5 is effective on January 30, 2001. The first phase-in of securities subject to the Rule will begin on Monday, April 2, 2001. As of this date, the Rule will apply to the 1000 NYSE securities, 1000 Nasdaq securities, and 200 Amex securities with the highest average daily share volume for the quarter ending December 31, 2000. On this first phase-in date, market centers must begin collecting the necessary data to prepare their monthly reports. In addition, they must make their first report, for April 2001, available by the end of May 2001. The second phase-in date will be July 2, 2001. From this date forward, the Rule will apply to the next 1000 NYSE securities, the next 1000 Nasdaq securities, and the next 200 Amex securities with the highest average daily share volume for the quarter ending March 31, 2001. The third and final phase-in of Rule 11Ac1–5 will begin on October 1, 2001. From this date forward, the Rule will apply to all national market system securities. As discussed in section VI.B below, the Commission believes that all market centers currently collect the basic order data that is necessary to generate the Rule's statistical measures. In addition, many market centers already prepare, or retain independent companies to prepare, similar statistical reports for private use. It is likely, therefore, that market centers will be able to make arrangements for production of reports under Rule 11Ac1–5 in advance of the compliance dates. If a market center believes that it will be unable to meet the compliance dates for good cause, it may request a temporary exemption from the Commission pursuant to paragraph (c) of the Rule. Finally, the Commission directs the national securities exchanges and the national securities association subject to Rule 11Ac1–5(b)(2) to comply with that provision by submitting a national market system plan to the Commission by no later than February 15, 2001.

Rule 11Ac1–6 also is effective on January 30, 2001. Broker-dealers must comply with the Rule for all covered securities on July 2, 2001. Accordingly, a broker-dealer's first report, for the quarter beginning in July and ending in September, must be made publicly available by the end of October 2001. In addition, broker-dealers would be required to respond to customer requests for information on orders that were routed on July 2, 2001, and after.

VI. Paperwork Reduction Act

As explained in the Proposing Release, certain provisions of Rule 11Ac1–5 and Rule 11Ac1–6 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[67] Accordingly, the Commission submitted the collection of information requirements contained in the rules to the Office of Management and Budget (''OMB'') for review. They were approved by OMB, which assigned the following control numbers: Rule 11Ac1–5, control number 3235–0542, and Rule 11Ac1–6, control number 3235–0541, with an expiration date for each of November 30, 2003. The collections of information are in accordance with section 3507 of the PRA.[68] With regard to Rule 11Ac1–5, the Commission staff has adjusted its PRA burden estimate in response to comments to include the potential for upfront preparations to comply with the data collection requirements of the Rule. With regard to Rule 11Ac1–6, the Commission staff has adjusted its PRA burden estimate to reflect a change from the rule as proposed that reduces the amount of information that broker-dealers will be required to disclose concerning their order routing practices. Accordingly, the Commission has submitted PRA change worksheets to OMB to reflect the adjusted estimates of the burden of compliance.

The collections of information relate to rules that will help further the national market system objectives set forth in Exchange Act section 11A(a)(1)(C). These objectives include the economically efficient execution of

[66] Currently, Rule 10b–10(a)(1) requires a broker-dealer to include the time of transaction on the confirmation of a transaction or a statement that the time of transaction will be furnished on written request. To assure consistency, paragraph (a)(9) of Rule 11Ac1–6 adopts the definition of the term ''time of the transaction'' set forth in Rule 10b–10(d)(3)—''the time of execution, to the extent feasible, of the customer's order.'' Broker-dealers must maintain customer order information to comply with Rule 10b–10 and other existing regulatory requirements. The Commission therefore disagrees with a commenter's assertion that the ''on request'' disclosures of Rule 11Ac1–6 would be costly and redundant. Schwab Letter, note 21 above, at 6. Another commenter doubted, as a matter of agency law, that ''any firm would presently fail to honor such a customer request.'' Datek Letter, note 58 above, at 5.

[67] 44 U.S.C. 3501 *et seq.*

[68] 44 U.S.C. 3507.

orders, fair competition among broker-dealers and among markets, the availability to broker-dealers and investors of information with respect to transactions in securities, and the practicability of brokers executing investors' orders in the best market. The collection of information obligations imposed by Rule 11Ac1–5 and Rule 11Ac1–6 are mandatory. The monthly order execution reports prepared and disseminated in electronic form by market centers pursuant to proposed Rule 11Ac1–5 will be available to the public and will not be kept confidential. Likewise, the quarterly order routing reports prepared and disseminated by broker-dealers pursuant to Rule 11Ac1–6 will be available to the public and will not be kept confidential. The individual responses by broker-dealers to customer requests for order routing information required by Rule 11Ac1–6 will be made available the customer and not to the general public. The Commission, SROs, and other securities regulatory authorities would gain possession of the responses only upon request. Any responses received by the Commission, SROs, and other securities regulatory authorities will be kept confidential to the extent permitted by the Freedom of Information Act.[69] An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

A. Comments on Collection of Information Requirements

The Commission requested public comment on the collection of information requirements contained in the Proposing Release. Commenters that addressed recordkeeping and reporting burdens generally focused their attention on the statistical disclosures required by Rule 11Ac1–5. Knight Trading Group, Inc. believed that Rule 11Ac1–5 would be ''feasible and implementable without undue burden on market centers because they already must produce much of the required information'' pursuant to existing regulatory requirements. Knight also noted that third party vendors could generate the required reports for market centers and that ''such an approach would offer an alternative for market centers that do not wish to incur the costs associated with developing and administering any systems needed to collect and disseminate the required information.'' [70] The Investment Company Institute stated that ''given technological advances in the dissemination of information and the wide use of the Internet by retail investors, we believe that the reports can be made available to the public in a reasonably efficient manner at a low cost.'' [71] In addition, the Transaction Auditing Group, Inc., a third party service provider for the analysis and reporting of execution quality, noted that ''as long as dissemination is permitted via the Internet, the collection, analysis and publication of large volumes of information would be feasible.[72]

Several other commenters, in contrast, suggested generally that complying with the recordkeeping and reporting requirements of Rule 11Ac1–5 would be burdensome for many market centers.[73] A comment letter submitted on behalf of five broker-dealer firms, for example, stated that, although the firms had ''not done a rigorous cost analysis with respect to the proposals, the Firms expect that the cost of compliance would be considerable, in terms of programming and monitoring tasks.'' [74] The CHX stated that the ''data capture, preparation and reporting burden involved in complying with proposed Rule 11Ac1–5 would be significant, even for the CHX, and, in all likelihood, excessive for many other market centers.'' [75] The Phlx estimated that ''the cost of creating the reporting system, as well as creating the interfaces with our members to meet their requirements under the Rule, would be at least $500,000 and require between six months and one year to fully implement.'' [76]

The Commission does not agree with these high estimates concerning the recordkeeping and reporting burden of Rule 11Ac1–5. As a basis for compliance, market centers themselves need maintain only the most basic order information, such as the type and size of order, the time of order receipt, the time of order execution, and execution price.[77] The Commission believes that all market centers retain this basic order data.[78] This data must then be compared with a record of the consolidated quote stream to generate the statistics required by Rule 11Ac1–5. Although some market centers may choose to program their own systems to perform this task, third party vendors already provide this service for many market centers. Based on Commission staff discussions with industry sources, it appears that individual market centers could obtain this service for approximately $2500 per month, and smaller market centers may be able to obtain this same service at an even lower cost. Accordingly, the Commission believes that the total costs to prepare the monthly order execution reports do not appear to be large for any market center.[79]

While the Commission received no comments that specifically addressed the PRA discussion of Rule 11Ac1–6, it did receive several comments that touched on PRA related issues. Most commenters supported improved disclosure of order routing practices by broker-dealers. Some, however, were concerned about the potentially long length and limited usefulness of some of the disclosure requirements included in the rule as proposed.[80] To maintain the brevity and reduce the compliance

[69] 5 U.S.C. 552 *et seq.*

[70] Knight Trading Letter, note 17 above, at 6, 9.

[71] ICI Letter, note 15 above, at 5.

[72] TAG Letter, note 17 above, at 2.

[73] *See, e.g.,* Charles Schwab Letter, note 21 above, at 12; CHX Letter, note 25 above, at 6; Morgan Stanley Letter, note 15 above, at 18; Letter from Deborah A. Lamb, Chair, Advocacy Advisory Committee, and Maria J.A. Clark, Associate, Association for Investment Management and Research, to Jonathan G. Katz, Secretary, SEC, dated Sept. 22, 2000, at 3–4.

[74] Wilkie Farr & Gallagher Letter, note 29 above, at 4.

[75] CHX Letter, note 25 above, at 6.

[76] Phlx Letter, note 25 above, at 3.

[77] In its comment letter, BRUT ECN disputed the Proposing Release's estimate of six hours per month to collect the data necessary to generate the monthly reports. It stated that its compliance would require ''upwards of 100 hours initially to ensure for the efficient generation of required data, although said process would streamline future compliance efforts.'' Letter from William O'Brien, Senior Vice President & General Counsel, The BRUT ECN, L.L.C., to Jonathan G. Katz, Secretary, SEC, dated Oct. 5, 2000, at 1 n. 3 (''BRUT Letter''). To reflect the potential for upfront preparations to comply with data collection requirements, the estimated burden of compliance in section VI.B below has been updated.

[78] For example, NASD rules require members trading Nasdaq securities to submit electronic data on individual order executions to the NASD pursuant to its Order Audit Trail System (''OATS'') requirements. NASD Rules 6950–6957. This data includes the basic order information that would be necessary to calculate the statistical measures of execution quality required by Rule 11Ac1–5. One commenter stated that it believed ''the NASD's OATS project, which entailed the development of data collection and warehousing on a similar scale, is a useful comparison of the development costs' of Rule 11Ac1–5. Schwab Letter, note 21 above, at 12. Market centers that already comply with the OATS data requirements, however, will have the Nasdaq order information necessary to comply with the data collection requirements of Rule 11Ac1–5.

[79] The CHX stated that the Proposing Release's ''estimate of six hours per month for each market center to generate the required reports seems to us unrealistically low.'' CHX Letter, note 25 above, at 6. The Proposing Release, however, separately addressed the issues of (1) data collection and (2) generation of the monthly reports from such data. The estimate of six hours per month applied solely to the burden of data *collection.* After the data is collected by market centers, it can be transferred to third party vendors with programs in place to generate the necessary reports. The Proposing Release estimated that vendors could provide this service for approximately $2500 per month.

[80] *See, e.g.,* Morgan Stanley Letter, note 15 above, at 15; NASD Letter, note 49 above, at 4; CBOE Letter, note 47 above, at 4–5.

burdens of the quarterly reports, the Commission has deleted several provisions from the proposed rule that would have required potentially long and complex disclosures. In particular, it has eliminated paragraph (b)(iv) of the proposed rule, which would have required a discussion of the significant objectives that the broker or dealer considered in determining where to route non-directed orders, the extent to which order executions achieved those objectives, a comparison of the quality of executions actually obtained with those produced by other venues for comparable orders during the relevant time period, and whether the broker or dealer has made or intends to make any material change in its order routing practices in the succeeding quarter. In addition, paragraph (b)(ii) has been altered so that a broker-dealer will not be required to identify every venue to which it routed any orders. Instead, only the top ten venues and any others that received 5% of more of the broker-dealer's orders must be disclosed.

One commenter addressed the burden of complying with paragraph (c) of Rule 11Ac1–6, which requires broker-dealers to provide, upon customer request, information regarding the customer's orders routed for execution in the six months prior to the request. The commenter asserted that ''it is apparent that this would be a time-consuming, burdensome and expensive requirement to fulfill.'' [81] The Commission strongly believes that those brokerage customers who express an interest in obtaining information about the routing of their own orders should have ready access to such information. Indeed, another commenter doubted that, as a matter of agency law, ''any firm would presently fail to honor such a customer request.'' [82] Particularly considering that the level of disclosure contained in the quarterly broker-dealer reports has been reduced, a requirement that broker-dealers respond to customer requests for order information will help assure that customers can obtain the data they need to evaluate the quality of their broker-dealer's services. Broker-dealers must retain customer order information to comply with existing regulatory requirements. The Commission does not believe that responding to customer requests for such information will constitute an unduly burdensome requirement for broker-dealers.

B. Total Annual Reporting and Recordkeeping Burdens

The collection of information obligations of Rule 11Ac1–5 will apply to all market centers that receive covered orders in national market system securities. Market centers are defined as exchange market makers, OTC market makers, alternative trading systems, national securities exchanges, and national securities associations. The Commission estimates that approximately 140 exchange market makers, 450 OTC market makers, 29 alternative trading systems, seven national securities exchanges, and one national securities association will be subject to the collection of information obligations of Rule 11Ac1–5. Each of these respondents will be required to respond to the collection of information on a monthly basis.

Rule 11Ac1–5 will require market centers to make available to the public monthly order execution reports in electronic form. To prepare the reports, market centers first will need to collect basic data on orders and executions (*e.g.,* type and size of order, time of order receipt and execution). Second, this data will need to be processed to calculate the statistics required by the Rule and present those statistics in an electronic report.

The Commission believes that market centers covered by the Rule retain all of the underlying raw data necessary to generate these reports in electronic format. Consequently, it does not appear that the Rule will require substantial additional data collection burdens. Commenters noted, however, that market centers may incur startup costs to prepare their systems to generate the specific data required by the Rule.[83] The Commission staff estimates that, on average, market centers could spend 90 hours to complete these preparations. Assuming internal staff costs of $53 per hour, the estimated 627 market centers could expend a total of approximately $3 million in startup costs, or a total of approximately $600,000 per year annualized over an expected useful life of five years. In addition, the Commission staff estimates that, on an ongoing basis, the Rule will cause respondents to spend an average of 6 hours per month in additional time to collect the data necessary to generate the reports, or 72 hours per year.[84] With an estimated 627 market centers subject to the Rule, the total data collection burden to comply with the monthly reporting requirement is estimated to be $600,000 per year for startup costs and 45,144 hours per year on an ongoing basis.

Once the necessary data is collected, market centers can either program their systems to generate the statistics and reports, or transfer the data to a service provider (such as an independent company in the business of preparing such reports or an SRO) that will generate the statistics and reports. Although the largest market centers and SROs may choose to generate the reports themselves, the Commission anticipates that the great majority of market centers will rely on service providers to prepare the reports for them. It is significantly more efficient to consolidate the processing and reporting function in a limited number of entities than for each market center to prepare its own reports. Once an entity has incurred the upfront costs of programming its systems to process data and generate a report for a single market center, there is very little additional cost to performing the same function for many additional market centers. Based on discussions with industry sources, the Commission staff estimates that an individual market center could retain a service provider to prepare a monthly report for approximately $2,500 per month. This per-respondent estimate is based on the rate that a market center could expect to obtain if it negotiated on an individual basis. Based on discussions with industry sources, we believe it is likely that a group of market centers, particularly the smaller members of a particular SRO, could obtain a much lower per-respondent rate on a collective basis. Thus, particularly for the smaller members of an SRO, the monthly cost to retain a service provider could be substantially less than $2,500. Based on the $2,500 estimate, however, the monthly cost to the 627 market centers to retain service providers to prepare reports would be $1,567,500, or an annual cost of approximately $18.8 million.

Rule 11Ac1–6 will require broker-dealers to prepare and disseminate quarterly order routing reports. Much of the information needed to generate these reports already should be collected by broker-dealers in

[81] Schwab Letter, note 21 above, at 6. In addition, another commenter believed that the proposed retention period of six months was ''onerous and unnecessary'' and that a 90-day time period would be sufficient. Edward Jones Letter, note 15 above, at 5. The Commission has retained the six-month period to assure that individual customers, after having an opportunity to review the quarterly reports giving a general overview of their broker-dealers' order routing practices, can obtain information concerning their own orders for the full period covered by the quarterly report.

[82] Datek Letter, note 58 above, at 5.

[83] *See* BRUT Letter, note 77 above, at 1.

[84] These figures could vary substantially among market centers. In addition, some SROs may provide this data collection service for their members because such centralized data collection is more efficient than data collection by individual members.

connection with their periodic evaluations of their order routing practices. To comply with the Rule, however, broker-dealers will incur additional burdens in preparing the reports and disseminating them on a free Internet web site (and responding to requests for written copies of the reports).

The collection of information obligations of Rule 11Ac1–6 will apply to all broker-dealers that route non-directed customer orders in covered securities. The Commission estimates that there are currently approximately 3800 broker-dealers that could be subject to the collection of information obligations of the Rule.[85] Each of these respondents (if engaged in the business of routing non-directed orders on behalf of customers) will be required to respond to the collection of information on a quarterly basis with respect to the Rule's reporting obligations, and on an ongoing basis with respect to the Rule's requirement to respond to customer requests for order routing information.

There are extreme differences in the nature of the securities business conducted by the approximately 3,800 broker-dealers that could be subject to the Rule. They range from the very largest firms with nationwide operations, which are relatively few in number, to thousands of much smaller introducing firms. To handle their customer accounts, these small firms rely primarily on clearing brokers. There currently are approximately 330 clearing brokers. The Commission previously has noted that ''from a functional perspective, introducing and clearing brokers act as a unit in handling a customer's account. In most respects, introducing brokers are dependent on clearing firms to clear and to execute customer trades, to handle customer funds and securities, and to handle many back-office functions, including issuing confirmations of customer trades and customer account statements.'' [86] The Commission anticipates that clearing brokers primarily will bear the burden of complying with the reporting and recordkeeping requirements of the Rule on behalf of many small introducing firms. In addition, however, there are approximately 610 introducing brokers that receive funds or securities from their customers.[87] Because at least some of these firms also may have greater involvement in determining where customer orders are routed for execution, they have been included, along with clearing brokers, in estimating the total burden of the Rule.

As discussed above, the reporting requirements of Rule 11Ac1–6 have been cut back from the proposed rule. The Commission staff estimates that each firm significantly involved in order routing practices will incur an average burden of 20 hours to prepare and disseminate a quarterly report required by Rule 11Ac1–6, or a burden of 80 hours per year. With an estimated 940 broker-dealers significantly involved in order routing practices, the total burden per year to comply with the quarterly reporting requirement in Rule 11Ac1–6 is estimated to be 75,200 hours.

Rule 11Ac1–6 also would require broker-dealers to respond to individual customer requests for information on orders handled by the broker-dealer for that customer. Clearing brokers generally would bear the burden of responding to these requests. The Commission staff estimates that each clearing broker will incur an average burden of 0.2 hours to prepare, deliver, and retain a response to a customer required by Rule 11Ac1–6. The annual burden could vary significantly among clearing brokers based on the number of customers and number of inquiries by each customer. The Commission staff estimates that an average clearing broker will incur an annual burden of 400 hours (2,000 responses × 0.2 hours/response) to prepare, disseminate and retain responses to customers required by the Rule. With an estimated 330 clearing brokers subject to the Rule, the total burden per year to comply with the customer response requirement in Rule 11Ac1–6 is estimated to be 132,000 hours.

VII. Cost-Benefit Analysis

The Commission is adopting two rules to improve public disclosure of broker-dealer and market center practices in the routing and execution of customer orders. The rules are intended to increase access to information about how investors' securities transactions are executed, thereby enhancing an investor's ability to make choices on the basis of execution criteria important to the particular investor. The required disclosures also should aid broker-dealers in satisfying their duty of best execution. The disclosures and enhanced investor knowledge should promote vigorous and beneficial competition among broker-dealers to seek out, and among market centers to provide, superior execution of customer orders.

A. Costs and Benefits of Rule 11Ac1–5

Under Rule 11Ac1–5, each market center (defined as any national securities exchange, national securities association, exchange market maker, OTC market maker, or alternative trading system) will be required to make monthly disclosure of certain statistical measures of execution quality on a security-by-security basis.[88] The Commission anticipates that the Rule will generate the benefits and costs described below.

1. Benefits

There currently is little or no publicly available information that would allow investors and broker-dealers to compare and evaluate execution quality among different market centers. Some market centers make order execution information privately available to independent companies, which then prepare reports on execution quality that are sold to broker-dealers. Other market centers provide reports on execution quality directly to broker-dealers or to their members. The information in these reports generally has not been publicly disseminated. Moreover, some broker-dealers have reported difficulty in obtaining useful information on execution quality from market centers. For example, participants in a Commission roundtable on the on-line brokerage industry indicated that not all market centers were willing to make order execution information available and, even when such information was made available, not all of it was useful or in a form that allowed for cross-market comparisons.

By improving public disclosure of execution quality, the Commission anticipates that the Rule will help broker-dealers fulfill their duty of best execution. That duty requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's order. Routing orders to a market center that merely guarantees an execution at the best published quote does not necessarily satisfy that duty; best

[85] This estimate is based on FYE 1999 FOCUS Reports received by the Commission. While there are currently approximately 7500 broker-dealers registered with the Commission, only approximately 3800 broker-dealers potentially route non-directed orders in covered securities.

[86] Securities Exchange Act Release No. 40122 (June 30, 1998), 63 FR 35508, n. 65.

[87] This estimate is based on FYE 1999 FOCUS Reports received by the Commission.

[88] As set out more specifically in section III.C above, the required disclosures will reflect statistical measures of such things as number of orders, number of shares, number of cancelled orders, size of spreads, frequency and size of price improvement, frequency of executions at the quote, frequency of executions outside the quote, and speed of execution (both with and without price improvement).

execution is a facts and circumstances determination. A broker-dealer must consider several factors affecting the quality of execution, including, for example, the opportunity for price improvement, the likelihood of execution (which is particularly important for customer limit orders), the speed of execution, and the trading characteristics of the security, together with other non-price factors such as reliability and service. While broker-dealers currently may be able to obtain order execution information from some market centers, that information may be of limited use and may not allow broker-dealers to compare execution quality among the different market centers. Although these statistics are by no means determinative of best execution, the Commission expects that the monthly reporting of the uniform statistical measures required by the Rule will provide broker-dealers with a clearer sense of execution quality among market centers, and will be helpful to broker-dealers in seeking to fulfill their duty of best execution.

The Commission also believes that the reporting required by Rule 11Ac1–5 will facilitate investors' ability to evaluate the quality of order executions provided by different market centers and to have meaningful input into how their broker-dealer executes their orders. Differences in execution quality across market centers can be very important to investors. For example, a difference in execution price of 1⁄16 for a 1000 share order can equal a savings of $62.50 for an investor. Currently, investors possess few tools to compare order executions on different markets, and they typically leave routing decisions to their broker-dealer. Different investors, however, may have different concerns and priorities related to execution of their orders, such as an opportunity for price improvement and the speed of execution. The Rule will require disclosure of information that will enhance investors' evaluation of these matters.

The Commission believes that Rule 11Ac1–5 will have the additional benefit of stimulating competition between market centers to improve the quality of their executions. Market centers compete to attract order flow. An important way in which market centers seek to attract order flow is by providing—and developing a reputation for providing—superior executions. The Rule will give broker-dealers and investors meaningful information, which they have not previously had, bearing on execution quality. Access to that information will allow broker-dealers and investors to direct orders to market centers on the basis of their order execution performance. Improved disclosure should result in some increase in the number of shares executed with price improvement and a reduction in the number of shares executed with price ''disimprovement.'' Price disimprovement can occur, for example, because of quote exhaustion—the cumulative volume of orders is greater than quoted size and the market center does not provide liquidity enhancement. The Commission anticipates that public disclosure will benefit investors by putting competitive pressure on market centers to reduce inefficiencies, to increase opportunities for price improvement, to decrease instances of price disimprovement, and to improve the quality of execution in all other respects. Market centers that are able to provide better service should be rewarded with more order flow. Ultimately, the Commission anticipates that these improvements in execution also will benefit investors by leading to reduced trading costs, increased trading quality, and possibly increased trading volume.

For example, if investors that now pay more than the median effective spread were able to obtain executions at the median effective spread, the required disclosures could save investors in Nasdaq stocks $110 million in annual trading costs.[89] Moreover, the savings to investors would be even greater if effective spreads improved to the level of the 25th percentile of Nasdaq market centers.[90] There also could be a similar type of benefit for investors in the listed markets, although possibly to a lesser extent given the smaller number of market centers. Finally, over time the disclosures rules may provide the impetus for new market structures that provide further reductions in trading costs.

In commenting on the costs and benefits of Rule 11Ac1–5, the Mercatus Center asserted that the potential savings in transaction costs for investors must also be counted as a cost to market intermediaries, noting that ''this sum is simply a transfer of wealth from brokers and market centers to investors'' and that ''when calculating the net benefits or costs of a rule, such wealth transfers cancel each other out.''[91] In contrast, we believe that the savings to investors described above may be associated with an additional net benefit that would be realized at the market centers. The ultimate result depends on what causes the differences in execution quality that we currently observe across market centers. If these differences are all due to differences in efficiency, then the potential savings to investors discussed above would necessarily be the result of transfers of order flow to the more efficient market centers. This consolidation would likely result in further efficiencies due to economies of scale.

On the other hand, the differences in transaction costs across market centers may reflect differing abilities by market centers to thwart competitive pressures and earn quasi-monopoly rents in the absence of adequate disclosure. If this were the case, then any investor savings might simply be the result of squeezing out some of these excess profits, with no attendant change in order routing practices. As the Mercatus Center points out, under this scenario the savings to investors represent a wealth transfer from the owners of the market centers. Of course, there are several other benefits to investors, discussed below, that flow from reduced transactions costs, even if one assumes that there are no net efficiency improvements available.

The savings calculation presented above implicitly assumes no change in the amount or type of transactions made by investors. Apart from direct savings to investors, a reduction in transaction costs will allow investors to manage their portfolios to better match their needs and desires, through a combination of rebalancing more frequently and incorporating a different mix of securities.[92] For example, some investors currently may avoid holding certain less-liquid securities because of transaction costs. After the Rule is implemented, they may want to include these securities in their portfolio if the Rule leads to a significant reduction in transaction costs.

Another potential benefit of reduced transactions costs is a reduction in the cost of capital applied to new investments. Amihud and Mendelson (1986)[93] provide both theoretical and empirical evidence that lower relative

[89] These savings are based on a sample of market orders for 10 high-volume Nasdaq securities from June 2000, and represent the projected benefits summed over all Nasdaq stocks for one year. The annual savings exclude changes in effective spread for marketable limit orders and for any trade greater than 4999 shares.

[90] Under this assumption, annual savings to Nasdaq investors would be approximately $175 million. These savings are calculated in the manner described in the preceding note.

[91] Mercatus Center Letter, note 29 above, at 16.

[92] The Mercatus Center's comment letter addresses the potential benefits associated with more frequent rebalancing, but ignores the potential changes in securities that investors choose.

[93] Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread,* 17 J. Financial Economics 223 (1986).

spreads are associated with lower required returns. Further, their empirical conclusions are supported by Brennan and Subrahmanyam (1996).[94] The intuition behind these studies is simple: in considering how much they are willing to pay for securities up front, investors consider how much of the future value will be lost to transaction costs.[95]

2. Costs

For purposes of the Paperwork Reduction Act, the Commission staff has estimated that compliance with Rule 11Ac1–5 by the estimated 627 market centers could require 56, 430 hours for initial preparations and, on an ongoing basis, impose 45,144 in burden hours for data collection and $18.8 million in other costs ($2,500 per month for preparation of reports by service vendors). The staff estimates that 100% of the burden hours could be expended by market centers' internal staff. Assuming internal staff costs of $53 per hour, the estimated 627 market centers could expend a total of approximately $600,000 per year in startup costs (a total of $3 million annualized over an expected useful life of five years) and a total of approximately $2.4 million per year in ongoing data collection costs. The estimated aggregate annual cost for compliance with the Rule could be approximately $21.8 million ($18.8 million+$2.4 million+$0.6 million).

Several commenters asserted that the costs of disclosing the execution quality information required by Rule 11Ac1–5 would be substantial. Many of these same commenters asserted that the benefits of the rules would be minimal and that the costs associated with the rules would outweigh the benefits.[96]

As discussed above in connection with the PRA, the Commission disagrees with these commenters' estimates regarding the direct costs of compliance with Rule 11Ac1–5. As a basis for compliance, market centers themselves need maintain only the most basic order information, such as the type and size of order, the time of order receipt, the time of order execution, and execution price. The Commission believes that all market centers retain this basic order data.[97] Such data then must be compared with a record of the consolidated quote stream to generate the statistics required by the Rule. Although some market centers may choose to program their own systems to perform this task, independent companies already provide this service for many market centers. These independent companies have expended the up-front costs of automating the processes and maintaining a record of the consolidated quote stream. Market centers need only transmit their basic order information to the service provider, which then is able to generate the necessary reports from the information. Based on discussions with industry sources, it appears that individual market centers could obtain this service for approximately $2,500 per month, and it is possible that smaller market centers could obtain this same service at an even lower cost. Accordingly, the total costs to prepare the monthly order execution reports do not appear to be large for any market center. The Commission believes the significant potential benefits from disclosure justify these costs.

B. Costs and Benefits of Rule 11Ac1–6

Under Rule 11Ac1–6, broker-dealers that route orders in equity and options securities on behalf of customers will be required to prepare quarterly reports that give an overview of their order routing practices. The Rule also will require broker-dealers to disclose to customers, on request, where that customer's individual orders were routed for execution.

1. Benefits

The Commission anticipates that improved disclosure of order routing practices will result in better-informed investors, will provide broker-dealers with more incentives to obtain superior executions for their customer orders, and will thereby increase competition between market centers to provide superior executions. Currently, the decision about where to route a customer order is frequently made by the broker-dealer, and broker-dealers may make that decision, at least in part, on the basis of factors that are unknown to their customers. The Rule's disclosure requirements will provide investors with a clearer picture of the overall routing practices of different broker-dealers. The Commission contemplates that this will lead to greater investor involvement in order routing decisions and, ultimately, will result in improved execution practices. Because of the disclosure requirements, broker-dealers may be more inclined (or investors may direct their broker-dealers) to route orders to market centers providing superior executions. Broker-dealers who fail to do so may lose customers to other broker-dealers who will do so. In addition, the improved visibility could shift order flow to those market centers that consistently generate the best prices for investors. This increased investor knowledge and involvement could ultimately have the effect of increasing competition between market centers to provide superior execution.

The order routing disclosures of Rule 11Ac1–6, when combined with the execution quality disclosure made by market centers, will allow investors to monitor the extent to which, in choosing execution venues, there are, in fact, systematic trade-offs that must be made between price and other factors, and the amount of those trade-offs. For example, if the best prices are consistently produced by one of the leading market centers with cutting-edge, highly-reliable trading systems, there would be little, if any, trade-off between price and systems reliability. Similarly, the rules will help customers weigh the trade-off between a market center that provided immediate executions at the quote, and a market center that executed orders on average in under 30 seconds, but that consistently generated prices resulting in average effective spreads that were a significant amount per share better than those paid by investors at other market centers. Currently, however, investors have little or no information that would allow them to evaluate how their broker-dealer has responded to such trade-offs. Rule 11Ac1–6, along with Rule 11Ac1–5, is intended to remedy this glaring absence of public information. After the rules become effective, competitive forces can be brought to bear on broker-dealers *both* with respect to the explicit trading costs associated with brokerage commissions and the implicit trading costs associated with execution quality. The Commission believes that investors ultimately will be the beneficiaries of this expanded competition.

[94] Michael J. Brennan & Avanidhar Subrahmanyam, *Market Microstructure and Asset Pricing: On the Compensation for Illiquidity in Stock Returns,* 41 J. Financial Economics 441 (1996).

[95] Both studies examine cross-sectional differences in required returns associated with cross-sectional differences in transaction costs so their empirical estimates may not be indicative of the size of the reduction in market-wide required returns that would accompany a market-wide reduction in transaction costs.

[96] Mercatus Center Letter, note 29 above, at 18; Phlx Letter, note 25 above, at 3; Morgan Stanley Letter, note 15 above, at 18; Wilkie Farr & Gallagher Letter, note 29 above, at 4.

[97] For example, NASD rules require members trading Nasdaq securities to submit electronic data on individual order executions to the NASD pursuant to its Order Audit Trail System requirements. NASD Rules 6950–6957. This data includes the basic order information that would be necessary to calculate the statistical measures of execution quality required by Rule 11Ac1–5.

2. Costs

For purposes of the Paperwork Reduction Act, the Commission staff has estimated that the Rule 11Ac1–6 could, on an annual basis, impose 75,200 burden hours on broker-dealers to comply with the quarterly reporting requirement of the Rule. The staff estimates that 100% of those burden hours will be expended by broker-dealers' internal staff. Assuming internal staff costs that average $85 per hour,[98] the aggregate annual cost of compliance with the quarterly reporting requirement could be approximately $6.4 million. In addition, compliance with the Rule will require staff time to respond to requests by customers for disclosure of the market centers to which their orders have been routed. For purposes of the Paperwork Reduction Act, the Commission staff has estimated that compliance with such requests could, on an annual basis, impose 132,000 burden hours. Assuming average internal staff costs of $53 per hour, the annual cost of compliance with the customer response requirement could be approximately $7 million.

As noted in section III.A.3 above, several commenters have raised concerns over the potential risk of meritless class-action suits faced by brokers as a result of increased disclosure. From society's perspective, the time and effort spent both asserting and defending any *meritless* action is a net cost. The Commission believes, however, that the potential for meritless litigation has been minimized by its inclusion of a Preliminary Note to Rule 11Ac1–5. The Note, with the attendant discussion in this release, states, among other things, that the statistical disclosures do not encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer and that the disclosures alone do not create a reliable basis to address whether any particular broker-dealer failed to meet its legal duty of best execution. This clear statement should substantially address the risk that the required disclosures will be misinterpreted and misused in private litigation. In light of the addition of the Preliminary Note and the best execution considerations addressed above, the Commission believes that the benefits of better visibility of execution quality justify any residual risk of meritless litigation arising after the additional information is publicly available.

VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact of such rules on competition.[99] In addition, section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[100]

The Commission has considered Rule 11Ac1–5 and Rule 11Ac1–6 in light of these standards and believes that the rules will not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. To the contrary, by enhancing the disclosure of order execution and order routing practices, the Rules should promote fair and vigorous competition. Investors currently have little information to evaluate the order routing practices of their broker-dealers. As a result, there currently may be limited opportunities for fair competition among broker-dealers based on the quality of their order routing services. By requiring broker-dealers to disclose information on their order routing practices, the Rules may stimulate competition among broker-dealers based on the quality of their order routing services. Similarly, by requiring market centers to disclose order execution information in a manner that permits comparative analysis, the rules may stimulate competition among market centers based on the quality of their order execution services. In addition, because the rules would apply equally to market centers, with respect to order execution disclosure, and broker-dealers, with respect to order routing disclosure, the rules would not result in disparate treatment of these entities that could hinder competition.

The Commission also believes that the rules will allow investors and broker-dealers to make better-informed choices in finding the best market for orders to be executed. Accordingly, the rules may promote market efficiency. In addition, the availability of information on order execution and order routing quality may bolster investor confidence, thereby promoting capital formation.

IX. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with the Regulatory Flexibility Act.[101] It relates to Rule 11Ac1–5 and Rule 11Ac1–6 under the Exchange Act. The rules will require market centers to make disclosures of order execution information and broker-dealers to make disclosures of order routing information.

A. Need for the Rules

The Commission believes that there is a need for improved disclosure of order execution information by market centers. Investors today can obtain consolidated quote information that represents the best bid and offer from among different market centers. This information, however, may not accurately reflect the quality of order executions that may be obtained from the different market centers. Many market centers offer significant opportunities for execution of orders at prices better that the consolidated quote. Conversely, some market centers execute orders at prices less favorable than the consolidated quote at the time of order receipt. The amount of price improvement or disimprovement may result in significant savings or costs to investors. Although some market centers make order execution information available to private companies or to their members, this information generally has not been publicly disseminated. Moreover, the lack of uniformity in the way this information is prepared has made it difficult for users of the information to compare execution quality across market centers.

The Commission also believes that there is a corresponding need for disclosure of order routing information by broker-dealers. If investors do not know where their broker-dealers route orders for execution, the order execution information provided by market centers will be of little benefit to investors. The lack of availability of order routing information also may make it difficult for investors to monitor their broker-dealer's order-routing decisions.

Rule 11Ac1–5 is designed to address the need for improved disclosure of order execution information by market centers. In particular, the Rule is intended to provide investors and broker-dealers with uniform information

[98] A higher average rate of internal staff costs is used for the preparation of quarterly reports based on the assumption that they would be prepared, at least in part, by higher level staff than that involved with responding to customer requests.

[99] 15 U.S.C. 78w(a).

[100] 15 U.S.C. 78c(f).

[101] 5 U.S.C. 601 *et seq.*

on execution quality that can be used to compare execution quality across market centers. This information should assist investors and broker-dealers in finding the best market for orders to be executed, thereby promoting competition among market centers and broker-dealers on the basis execution quality and leading to more efficient transactions in securities.

Rule 11Ac1–6 is designed to address the complementary need for broker-dealers to disclose to customers where their orders are routed for execution. The primary objective of the rule is to afford customers a greater opportunity to monitor their broker-dealer's order routing practices. Supplied with information on where their orders are routed, as well as information about the quality of execution from the market centers to which their orders are routed, investors will be able to make better informed decisions with respect to their orders. The information also may assist investors in selecting a broker-dealer.

B. Significant Issues Raised By Public Comment

No commenter specifically addressed the Initial Regulatory Flexibility Analysis that was included in the Proposing Release. Some commenters stated, however, that they believed compliance with the proposed rules, particularly Rule 11Ac1–5, could be significantly more burdensome for smaller firms than for large ones.[102] As discussed below, the Commission does not agree that compliance with the rules will be unduly burdensome for those entities that are considered small entities for purposes of the Regulatory Flexibility Act.

C. Small Entities Subject To the Rules

Both Rule 11Ac1–5 and Rule 11Ac1–6 will affect entities that are considered small entities for purposes of the Regulatory Flexibility Act.

1. Small Entities Affected By Rule 11Ac1–5

Rule 11Ac1–5 will impose disclosure requirements on every market center that receives covered orders in national market system securities. Market centers are defined as exchange market makers, OTC market makers, alternative trading systems, national securities exchanges, and national securities associations.

Exchange market makers, OTC market makers, and alternative trading systems that are not registered as exchanges are required to register as broker-dealers. Accordingly, these entities would be considered small entities if they fall within the standard for small entities that applies to broker-dealers. Under Exchange Act Rule 0–10(b), a broker-dealer is considered a small entity for purposes of Regulatory Flexibility Act if (1) it had total capital of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, of, if not required to prepare such statements, it had total capital of less than $500,000 on the last business day of the preceding fiscal year, and (2) it is not affiliated with any person (other than a natural person) that is not a small entity.[103] Based on this standard, the Commission estimates that two exchange market makers, one OTC market maker, and no alternative trading systems that will be subject to Rule 11Ac1–5 are small entities.[104]

None of the national securities exchanges or the national securities association subject to the Rule is a small entity. Paragraph (e) of the Exchange Act Rule 0–10[105] provides that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of 17 CFR 240.11Aa3–1. Under this standard, none of the national securities exchanges affected by the Rule is a small entity. Similarly, the national securities association subject to the Rule is not a small entity as defined by 13 CFR 121.201.

2. Small Entities Affected By Rule 11Ac1–6

Rule 11Ac1–6 will impose disclosure requirements on every broker-dealer that routes non-directed customer orders in covered securities. Under the standard for determining whether a broker-dealer is a small entity in Exchange Act Rule 0–10(b), the Commission estimates that approximately 41 broker-dealers subject to Rule 11Ac1–6 are small entities.[106]

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

1. Reporting Requirements Under Rule 11Ac1–5

Rule 11Ac1–5 will impose new reporting requirements on market centers, including those considered small entities. Under the Rule, market centers will be required to prepare and make available to the public monthly reports that categorize and summarize their order executions. For purposes of the Paperwork Reduction Act, the Commission staff estimates that individual market centers will spend 90 hours in initial preparations and, on an annual basis, spend 72 burden hours and incur $30,000 ($2,500 per month) in monetary costs to comply with the monthly reporting requirement. Assuming internal compliance staff costs of $53 per hour, the total cost per small entity for burden hours will be $4,770 for initial preparations and $3,816 on an annual basis. The Commission estimates the total cost, on an ongoing basis, required to prepare and disseminate the monthly reports by the estimated three small entities subject to the Rule will be $108,360 per year (3 × ($30,000 + $3,816)). As discussed further above, small entities likely could obtain a much reduced rate through the auspices of an SRO or other organization.

2. Reporting Requirements Under Rule 11Ac1–6

Rule 11Ac1–6 will impose new reporting requirements on broker-dealers, including those considered small entities. Under the Rule, broker-dealers will be required to prepare and make available to the public quarterly reports that give an overview of their routing of non-directed orders in covered securities. In addition, broker-dealers, on request of a customer, will be required to disclose the identity of the venues to which the customer's orders were routed in the six months prior to the request, whether the orders were directed or non-directed orders, and the time of the transactions resulting from such orders.

As discussed in section VI.B above, it is unlikely that many small entities will have significant involvement in order routing practices, primarily because they are affiliated with a clearing broker. With respect to the 41 small entities that are subject to the Rule and are not affiliated with a clearing broker, the Commission does not anticipate that they engage in significant order routing on behalf of customers. If any of the 41 small entities were required to comply with the Rule, the Commission staff estimates that they would expend, on average, 32 hours to prepare quarterly reports and 2 hours to respond to eight customer requests.[107] Assuming internal

[102] Morgan Stanley Letter, note 15 above, at 18; Wilkie Farr & Gallagher Letter, note 29 above, at 4.

[103] Exchange Act Rule 0–10(b), 17 CFR 240.0–10(c).

[104] These estimates are based on the FYE 1999 FOCUS Reports received by the Commission from exchange market makers, OTC market makers, and ATSs that would be subject to Rule 11Ac1–5.

[105] 17 CFR 240.0–10(e).

[106] This estimate is based on the FYE 1999 FOCUS Reports received by the Commission from broker-dealers subject to Rule 11Ac1–6.

[107] These estimates are smaller than those used generally to estimate the burden costs for purposes of the Paperwork Reduction Act. Assuming any of

Continued

compliance costs that average $85 per hour, the aggregate cost for each small entity to comply with the Rule is estimated to be $2890.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with Rule 11Ac1–5 and Rule 11Ac1–6, the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

1. Rule 11Ac1–5

Rule 11Ac1–5 is designed to provide uniform order execution information from the different market centers to allow investors and broker-dealers to compare execution quality across markets. Accordingly, the Commission believes that establishing differing reporting requirements for small entities would be inconsistent with the objectives of the Rule. Similarly, the Commission believes that the clarification, consolidation, or simplification of reporting requirements for small entities would be inconsistent with the objective of providing uniform order execution information from the different market centers.

Regarding the use of performance standards rather than design standards, Rule 11Ac1–5 specifies the statistical measures that must appear in the monthly order execution reports. The Commission considered whether the Rule should require market centers only to make available electronic files with raw data on an order-by-order basis. Under this alternative, market centers would provide the necessary fields of information, and analysts could calculate the statistical measures of execution quality that they consider appropriate. The Commission has not adopted this alternative because it would be inconsistent with the objective of assuring a uniform basis for comparing execution quality across market centers. The Rule does not establish a particular technology for disseminating the required reports to the public, other than requiring that market centers make their data available for downloading from a free website in a consistent, usable, and machine-readable electronic format.

As to whether Rule 11Ac1–5 should exempt small entities from its coverage, the Commission considered several alternatives that could minimize the impact of the Rule on small entities. Specifically, the Commission considered an exemption for market centers that execute relatively few orders in total. Also, the Commission considered an exemption to eliminate the disclosure requirement for individual securities in which a market center executes relatively few orders. Finally, as discussed above, the Commission considered whether it would be feasible to allow small market centers to provide raw data rather than the statistical measures required by the proposed rule. No commenters expressed support for these types of exemptions or exceptions for small entities. Given the need for a uniform basis to compare execution quality across market centers, the Commission has determined not to adopt exemptions or exclusions specifically for small entities.

2. Rule 11Ac1–6

Rule 11Ac1–6 is designed to provide investors with information on the order routing practices of their broker-dealers. The Rule requires broker-dealers to prepare quarterly order routing reports and respond to requests from individual investors for information on how their orders were routed. As to the establishment of different reporting requirements or timetables and the clarification, consolidation, or simplification of reporting requirements for small entities, the Commission does not believe that the proposal could be formulated differently for small entities and still achieve its stated objectives.

The Commission requested comment on whether to exclude from the Rule broker-dealers that route a relatively small number of customer orders. No commenter expressed support for such an exclusion. Moreover, an exemption from the Rule for small entities would be inconsistent with the objectives of the Rule. Its primary objective is to afford customers a greater opportunity to monitor their broker-dealer's order routing practices. All broker-dealers currently have an obligation to periodically review their order routing practices to meet their duty of best execution to their customers. The Commission does not believe that the disclosures required by Rule 11Ac1–6 will be unduly burdensome for small entities, particularly now that the requirement of a narrative discussion and analysis of order routing objectives and results has been eliminated from the rule as it was proposed.

X. Statutory Authority

Pursuant to the Exchange Act and particularly Sections 3(b), 5, 6, 11A, 15, 17, 19, 23(a), and 36 thereof, 15 U.S.C. 78c, 78e, 78f, 78k–1, 78o, 78q, 78s, 78w(a), and 78mm, the Commission proposes to adopt Sections 240.11Ac1–5 and 240.11Ac1–6 of Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below.

List of Subjects in 17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

Text of Rules

For the reasons set forth in the preamble, the Commission is amending Chapter II of Title 17 of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Sections 240.11Ac1–5 and 240.11Ac1–6 are added before the undesignated center heading ''Securities Exempted from Registration'' to read as follows:

§ 240.11Ac1–5 Disclosure of order execution information.

Preliminary Note: Section 240.11Ac1–5 requires market centers to make available standardized, monthly reports of statistical information concerning their order executions. This information is presented in accordance with uniform standards that are based on broad assumptions about order execution and routing practices. The information will provide a starting point to promote visibility and competition on the part of market centers and broker-dealers, particularly on the factors of execution price and speed. The disclosures required by this section do not

the 41 small entities actually route non-directed orders on behalf of customers, it is likely that the number of orders would be very small. The burden of preparing quarterly reports and responding to customer requests would therefore be substantially less than the overall industry average.

encompass all of the factors that may be important to investors in evaluating the order routing services of a broker-dealer. In addition, any particular market center's statistics will encompass varying types of orders routed by different broker-dealers on behalf of customers with a wide range of objectives. Accordingly, the statistical information required by this Section alone does not create a reliable basis to address whether any particular broker-dealer failed to obtain the most favorable terms reasonably available under the circumstances for customer orders.

(a) *Definitions.* For the purposes of this section:

(1) The term *alternative trading system* shall have the meaning provided in § 242.300(c) of this chapter.

(2) The term *average effective spread* shall mean the share-weighted average of effective spreads for order executions calculated, for buy orders, as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer at the time of order receipt and, for sell orders, as double the amount of difference between the midpoint of the consolidated best bid and offer at the time of order receipt and the execution price.

(3) The term *average realized spread* shall mean the share-weighted average of realized spreads for order executions calculated, for buy orders, as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer five minutes after the time of order execution and, for sell orders, as double the amount of difference between the midpoint of the consolidated best bid and offer five minutes after the time of order execution and the execution price; provided, however, that the midpoint of the final consolidated best bid and offer disseminated for regular trading hours shall be used to calculate a realized spread if it is disseminated less than five minutes after the time of order execution.

(4) The term *categorized by order size* shall mean dividing orders into separate categories for sizes from 100 to 499 shares, from 500 to 1999 shares, from 2000 to 4999 shares, and 5000 or greater shares.

(5) The term *categorized by order type* shall mean dividing orders into separate categories for market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders.

(6) The term *categorized by security* shall mean dividing orders into separate categories for each national market system security that is included in a report.

(7) The term *consolidated best bid and offer* shall mean the highest firm bid and the lowest firm offer for a security that is calculated and disseminated on a current and continuous basis pursuant to an effective national market system plan.

(8) The term *covered order* shall mean any market order or any limit order (including immediate-or-cancel orders) received by a market center during regular trading hours at a time when a consolidated best bid and offer is being disseminated, and, if executed, is executed during regular trading hours, but shall exclude any order for which the customer requests special handling for execution, including, but not limited to, orders to be executed at a market opening price or a market closing price, orders submitted with stop prices, orders to be executed only at their full size, orders to be executed on a particular type of tick or bid, orders submitted on a ''not held'' basis, orders for other than regular settlement, and orders to be executed at prices unrelated to the market price of the security at the time of execution.

(9) The term *exchange market maker* shall mean any member of a national securities exchange that is registered as a specialist or market maker pursuant to the rules of such exchange.

(10) The term *executed at the quote* shall mean, for buy orders, execution at a price equal to the consolidated best offer at the time of order receipt and, for sell orders, execution at a price equal to the consolidated best bid at the time of order receipt.

(11) The term *executed outside the quote* shall mean, for buy orders, execution at a price higher than the consolidated best offer at the time of order receipt and, for sell orders, execution at a price lower than the consolidated best bid at the time of order receipt.

(12) The term *executed with price improvement* shall mean, for buy orders, execution at a price lower than the consolidated best offer at the time of order receipt and, for sell orders, execution at a price higher than the consolidated best bid at the time of order receipt.

(13) The terms *inside-the-quote limit order, at-the-quote limit order, and near-the-quote limit order* shall mean non-marketable buy orders with limit prices that are, respectively, higher than, equal to, and lower by $0.10 or less than the consolidated best bid at the time of order receipt, and non-marketable sell orders with limit prices that are, respectively, lower than, equal to, and higher by $0.10 or less than the consolidated best offer at the time of order receipt.

(14) The term *market center* shall mean any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association.

(15) The term *marketable limit order* shall mean any buy order with a limit price equal to or greater than the consolidated best offer at the time of order receipt, and any sell order with a limit price equal to or less than the consolidated best bid at the time of order receipt.

(16) The term *effective national market system plan* shall have the meaning provided in § 240.11Aa3–2(a)(2).

(17) The term *national market system security* shall have the meaning provided in § 240.11Aa2–1.

(18) The term *OTC market maker* shall mean any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, a national market system security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(19) The term *regular trading hours* shall mean the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to paragraph (c)(2) of this section.

(20) The term *time of order execution* shall mean the time (to the second) that an order was executed at any venue.

(21) The term *time of order receipt* shall mean the time (to the second) that an order was received by a market center for execution.

(b) *Monthly electronic reports by market centers.* (1) Every market center shall make available for each calendar month, in accordance with the procedures established pursuant to paragraph (b)(2) of this section, a report on the covered orders in national market system securities that it received for execution from any person. Such report shall be in electronic form; shall be categorized by security, order type, and order size; and shall include the following columns of information:

(i) For market orders, marketable limit orders, inside-the-quote limit orders, at-the-quote limit orders, and near-the-quote limit orders:

(A) The number of covered orders;

(B) The cumulative number of shares of covered orders;

(C) The cumulative number of shares of covered orders cancelled prior to execution;

(D) The cumulative number of shares of covered orders executed at the receiving market center;

(E) The cumulative number of shares of covered orders executed at any other venue;

(F) The cumulative number of shares of covered orders executed from 0 to 9 seconds after the time of order receipt;

(G) The cumulative number of shares of covered orders executed from 10 to 29 seconds after the time of order receipt;

(H) The cumulative number of shares of covered orders executed from 30 seconds to 59 seconds after the time of order receipt;

(I) The cumulative number of shares of covered orders executed from 60 seconds to 299 seconds after the time of order receipt;

(J) The cumulative number of shares of covered orders executed from 5 minutes to 30 minutes after the time of order receipt; and

(K) The average realized spread for executions of covered orders; and

(ii) For market orders and marketable limit orders:

(A) The average effective spread for executions of covered orders;

(B) The cumulative number of shares of covered orders executed with price improvement;

(C) For shares executed with price improvement, the share-weighted average amount per share that prices were improved;

(D) For shares executed with price improvement, the share-weighted average period from the time of order receipt to the time of order execution;

(E) The cumulative number of shares of covered orders executed at the quote;

(F) For shares executed at the quote, the share-weighted average period from the time of order receipt to the time of order execution;

(G) The cumulative number of shares of covered orders executed outside the quote;

(H) For shares executed outside the quote, the share-weighted average amount per share that prices were outside the quote; and

(I) For shares executed outside the quote, the share-weighted average period from the time of order receipt to the time of order execution.

(2) Every national securities exchange on which national market system securities are traded and national securities association shall act jointly in establishing procedures for market centers to follow in making available to the public the reports required by paragraph (b)(1) of this section in a uniform, readily accessible, and usable electronic form. In the event there is no effective national market system plan establishing such procedures, market centers shall prepare their reports in a consistent, usable, and machine-readable electronic format, and make such reports available for downloading from an Internet web site that is free and readily accessible to the public.

(3) A market center shall make available the report required by paragraph (b)(1) of this section within one month after the end of the month addressed in the report.

(c) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

§ 240.11Ac1–6 Disclosure of order routing information.

(a) *Definitions.* For the purposes of this section:

(1) The term *covered security* shall mean:

(i) Any national market system security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as defined in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)); and

(ii) Any option contract traded on a national securities exchange for which last sale reports and quotation information are made available pursuant to an effective national market system plan.

(2) The term *customer order* shall mean an order to buy or sell a covered security that is not for the account of a broker or dealer, but shall not include any order for a quantity of a security having a market value of at least $50,000 for a covered security that is an option contract and a market value of at least $200,000 for any other covered security.

(3) The term *directed order* shall mean a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution.

(4) The term *make publicly available* shall mean posting on an Internet web site that is free and readily accessible to the public, furnishing a written copy to customers on request without charge, and notifying customers at least annually in writing that a written copy will be furnished on request.

(5) The term *non-directed order* shall mean any customer order other than a directed order.

(6) The term *effective national market system plan* shall have the meaning provided in § 240.11Aa3–2(a)(2).

(7) The term *national market system security* shall have the meaning provided in § 240.11Aa2–1.

(8) The term *payment for order flow* shall have the meaning provided in § 240.10b–10(d)(9).

(9) The term *profit-sharing relationship* shall mean any ownership or other type of affiliation under which the broker or dealer, directly or indirectly, may share in any profits that may be derived from the execution of non-directed orders.

(10) The term *time of the transaction* shall have the meaning provided in § 240.10b–10(d)(3).

(b) *Quarterly report on order routing.* (1) Every broker or dealer shall make publicly available for each calendar quarter a report on its routing of non-directed orders in covered securities during that quarter. For covered securities other than option contracts, such report shall be divided into three separate sections for securities that are listed on the New York Stock Exchange, Inc., securities that are qualified for inclusion in the Nasdaq Stock Market, Inc., and securities that are listed on the American Stock Exchange LLC or any other national securities exchange. Such report also shall include a separate section for covered securities that are option contracts. Each of the four sections in a report shall include the following information:

(i) The percentage of total customer orders for the section that were non-directed orders, and the percentages of total non-directed orders for the section that were market orders, limit orders, and other orders;

(ii) The identity of the ten venues to which the largest number of total non-directed orders for the section were routed for execution and of any venue to which five percent or more of non-directed orders were routed for execution, the percentage of total non-directed orders for the section routed to the venue, and the percentages of total non-directed market orders, total non-directed limit orders, and total non-directed other orders for the section that were routed to the venue; and

(iii) A discussion of the material aspects of the broker's or dealer's relationship with each venue identified pursuant to paragraph (b)(1)(ii) of this section, including a description of any arrangement for payment for order flow and any profit-sharing relationship.

(2) A broker or dealer shall make the report required by paragraph (b)(1) of this section publicly available within one month after the end of the quarter addressed in the report.

(c) *Customer requests for information on order routing.* (1) Every broker or dealer shall, on request of a customer, disclose to its customer the identity of the venue to which the customer's orders were routed for execution in the six months prior to the request, whether the orders were directed orders or non-directed orders, and the time of the transactions, if any, that resulted from such orders.

(2) A broker or dealer shall notify customers in writing at least annually of the availability on request of the information specified in paragraph (c)(1) of this section.

(d) *Exemptions.* The Commission may, by order upon application, conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this section, if the Commission determines that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Dated: November 17, 2000.

By the Commission.

Jonathan G. Katz,

Secretary.

[FR Doc. 00–30131 Filed 11–30–00; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–43591; File No. S7–17–00]

RIN 3235–AH96

Firm Quote and Trade-Through Disclosure Rules for Options

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting an amendment to Rule 11Ac1–1 under the Securities Exchange Act of 1934 ("Exchange Act") to require options exchanges and options market makers to publish firm quotes. The Commission also is adopting new Rule 11Ac1–7 under the Exchange Act to require a broker-dealer to disclose to its customer when its customer's order for listed options is executed at a price inferior to a better published quote and what that better quote was, unless the transaction was effected on a market that is a participant in an intermarket options linkage plan approved by the Commission. These rules will facilitate the ability of market participants to obtain the best price for customer orders.

EFFECTIVE DATE: February 1, 2001.

FOR FURTHER INFORMATION CONTACT: Deborah Flynn, Senior Special Counsel, at (202) 942–0075, Kelly Riley, Special Counsel, at (202) 942–0752, John Roeser, Attorney, at (202) 942–0762, Terri Evans, Special Counsel, at (202) 942–4162, and Heather Traeger, Attorney, at (202) 942–0763, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Executive Summary

Recent increases in the multiple listing of options classes previously listed on a single exchange have intensified the competition among the option exchanges and heightened the need to further integrate the options markets into the national market system. The marked increase in multiple trading is indicative of the dynamic environment in which the options markets currently operate.[1] While the growth in multiple trading has increased the competition between markets, it also has dramatically altered the environment in which options market participants conduct their trading. In particular, multiple trading raises new best execution challenges for brokers.[2] When an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is simpler than when they must consider the relative merits of routing an order to two or more market centers. With as many as five options exchanges currently trading

---

[1] For example, in August 1999, only 32% of equity options classes were traded on more than one exchange. By the end of September 2000, the number of equity options classes that were multiply-traded had risen to 45%. In addition, aggregate options volume traded only on a single exchange fell from 61% to 15% over this same period.

[2] In accepting orders and routing them to an exchange for execution, brokers act as agents for their customers and owe them a duty of best execution. A broker's duty of best execution is derived from common law agency principles and fiduciary obligations. It is incorporated both in self-regulatory organizations' rules and in the antifraud provisions of the federal securities laws through judicial and Commission decisions. This duty requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. As a result, brokers must periodically assess the quality of competing markets. See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

certain options classes, brokers are required to regularly and rigorously evaluate the execution quality available at each options exchange.

Directly relevant to a broker's ability to obtain best execution for its customers is the ability to get the best price available. The considerable growth in the number of options classes traded on more than one exchange has significantly increased the likelihood that an order may be executed at a price that is inferior to a quoted price available on another exchange (''intermarket trade-through''). According to preliminary data analyzed by the Commission's Office of Economic Analysis, during the week of June 26, 2000, 5 percent of all trades in the 50 most active multiply-traded equity options were executed at prices inferior to the best price quoted on a competing market. Currently, it is difficult to ensure that a customer order sent to one exchange will receive the best available price because of the absence of fair access and an efficient mechanism allowing a market participant at one exchange to reach a better price published by another exchange. As a result, better prices quoted on another exchange do not always receive price priority, and customer orders may receive inferior executions.

Because of our concerns about the increasing likelihood of intermarket trade-throughs in the options markets, on October 19, 1999, the Commission issued an Order directing the options exchanges to act jointly to file a national market system plan for linking the options markets.[3] On July 28, 2000, the Commission approved an intermarket linkage plan proposed by three of the options exchanges (''Linkage Plan'')[4] and subsequently, the other two exchanges filed with the Commission amendments to permit their participation in the Linkage Plan.[5]

In conjunction with its approval of the Linkage Plan, the Commission proposed a new rule, Exchange Act Rule 11Ac1–7 (''Trade-Through Disclosure Rule''),[6] to require a broker-dealer to disclose to its customer when the customer's order for a listed option is executed at a price inferior to a better published quote and that better quote, unless the transaction was effected on a market that participates in an intermarket linkage plan approved by the Commission.[7] In addition, the Commission proposed to amend Exchange Act Rule 11Ac1–1 (''Quote Rule'')[8] to require options exchanges and options market makers to publish firm quotes.[9] These proposed rules were intended to facilitate the ability of market participants to obtain the best price for customer orders without mandating a specific linkage.

With the current expansion of multiple trading in options, the Commission is increasingly concerned about intermarket trade-throughs of customer orders. The Commission believes that adoption of the new rule and amendment to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on another market. Consequently, as discussed below, the Commission today is adopting the Trade-Through Disclosure Rule[10] and amending the Quote Rule,[11] substantially as proposed, with certain modifications recommended by commenters.

II. Background

Section 11A of the Exchange Act,[12] enacted as part of the Securities Acts Amendments of 1975,[13] sets forth Congress' findings concerning the establishment of a national market system. Congress found, among other things, that it was in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability to brokers, dealers, and investors of quote and transaction information.[14] Congress also found that linking all of the markets for qualified securities would ''foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.''[15]

The national market system was intended by Congress to potentially encompass ''all segments of corporate securities including all types of common and preferred stocks, bonds, debentures, warrants, and options.''[16] Congress included all types of securities because it believed that many of the goals of a national market system, such as the availability of information with respect to price, volume, and quotations, would be universally beneficial.[17]

Congress did, however, recognize the differences between the markets and granted the Commission broad powers to implement a national market system without forcing all securities markets into a single mold.[18] Accordingly, Congress granted the Commission the authority to implement the objectives of the 1975 Amendments,[19] while allowing the Commission to recognize and classify markets, firms, and securities in any manner appropriate or necessary in the public interest or for the protection of investors.[20]

Many of the national market system initiatives were implemented in the equities markets at a time when

[3] *See* Securities Exchange Act Release No. 42029, 64 FR 57674 (October 26, 1999) (''October 19, 1999 Order''). The October 19, 1999 Order directed the American Stock Exchange LLC (''Amex''), Chicago Board Options Exchange, Inc. (''CBOE''), Pacific Exchange, Inc. (''PCX''), and Philadelphia Stock Exchange, Inc. (''Phlx'') to act jointly in discussing, developing, and submitting for Commission approval an intermarket linkage plan. The Commission's Order also requested the International Securities Exchange LLC (''ISE'') to participate with the options exchanges in the development of an intermarket linkage plan. The ISE was subsequently registered as a national securities exchange for options trading on February 24, 2000. *See* Securities Exchange Act Release No. 42455, 65 FR 11387 (March 2, 2000).

[4] *See* Securities Exchange Act Release No. 43086, 65 FR 48023 (August 4, 2000). As originally approved, the Amex, CBOE, and ISE were the only participants in the Linkage Plan.

[5] *See* Securities Exchange Act Release Nos. 43573 (November 16, 2000); and 43574 (November 16, 2000). The Commission issued orders to permit Phlx and PCX to participate in the Linkage Plan.

[6] Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

[7] *See* Securities Exchange Act Release No. 43085 (July 28, 2000), 65 FR 47918 (August 4, 2000) (''Proposing Release'').

[8] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[9] *See* Proposing Release, supra note 7.

[10] Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

[11] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[12] 15 U.S.C. 78k–1.;

[13] Pub. L. No. 94–29, 89 Stat. 97 (1975) (''1975 Amendments''). In the 1975 Amendments, Congress directed the Commission to oversee the development of a national market system. Congress granted the Commission broad, discretionary powers to oversee the development of a fully integrated national market system for the processing and settlement of securities transactions. See also infra note 16.

[14] Section 11A(a)(1)(C) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(C).

[15] Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k–1(a)(1)(D).

[16] Senate Committee on Banking, Housing, and Urban Affairs, Report to Accompany S. 249, S. Rep. 94–75, 94th Cong., 1st Sess. 7 (1975) (''Senate Report''). *See* also Committee of Conference, Report to Accompany S. 249, H.R. Rep. No. 94–229, 94th Cong., 1st Sess. 2 (1975) (''Conference Report'').

[17] Id.

[18] *See* Senate Report. See also Conference Report. In the Conference Report, the Committee stated that the unique characteristics of securities other than common stocks may require different treatment in a national market system.

[19] The two primary objectives of the 1975 Amendments were (1) ''the maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements,'' and (2) ''the centralization of all buying and selling interest so that each investor will have the opportunity for the best execution of his order, regardless of where in the system it originates.'' See Senate Report.

[20] Section 11A(a)(2) of the Exchange Act authorizes the Commission to designate, by rule, securities qualified for trading in the national market system. 15 U.S.C. 78k–1(a)(2).

standardized options trading was relatively new.[21] Therefore, even though Congress had intended to include options in a national market system, the Commission deferred applying many of the national market system initiatives to options to give options trading an opportunity to develop.[22] Today, the options markets continue to operate with limited market integration facilities.[23]

A. Prior Attempts To Limit Intermarket Trade-Throughs

To address the limited market integration facilities in the options market, the Commission has repeatedly encouraged the exchanges to implement mechanisms to limit trade-throughs.[24] For example, in 1980, at the time the Commission ended the voluntary moratorium on expansion of standardized options trading, it asked for comment on several approaches to more fully integrate the options markets into the national market system, including a market linkage system similar to the Intermarket Trading System (''ITS''),[25] requiring brokerage firms to route retail orders on an order-by-order basis to the market center showing the best quotation, and an order exposure system for options public limit orders.[26]

Subsequently, the Commission's adoption of Exchange Act Rule 19c-5 in 1989 [27] created the need for some mechanism to ensure that customers' orders for multiply-traded options could be executed at the best available price. Accordingly, in 1990, the Amex, CBOE, New York Stock Exchange (''NYSE''),[28] and PCX filed with the Commission a proposed Joint Industry Plan providing for the creation and operation of an Options Intermarket Communications Linkage (''Proposed Plan'').[29] The Commission sought comment on the Proposed Plan,[30] but neither the Proposed Plan nor its Model Trade-Through Rule was adopted, in part, because the options exchanges could not reach a consensus on several critical elements.

During the comment period on the Proposed Plan, an alternative plan was considered that involved the gradual phase-in of multiple trading, along with the adoption of exchange rules and operational enhancements linking the markets non-electronically (''Phase-In Plan'').[31] Specifically, the Phase-In Plan would have provided for the re-routing of orders received through automated systems to other execution facilities, in conjunction with a trade-or-fade rule.[32] Again, however, the exchanges did not agree to the Phase-In Plan and it was not adopted.

In 1994, the markets adopted trade-or-fade rules, which require a market maker to revise its quote if it is unwilling to trade at its published quote with an order sent to it by a market maker from another exchange.[33] The trade-or-fade rules do not provide efficient means of access between the markets. They also provide little incentive to try to reach a better quote

[21] The trading of standardized options on securities exchanges began in 1973 with the organization of the CBOE as a national securities exchange. *See* Securities Exchange Act Release No. 9985 (February 1, 1973) 1 S.E.C. Doc. 11 (February 13, 1973). Currently, Amex, CBOE, ISE, PCX, and Phlx are the only national securities exchanges that trade standardized options.

[22] In October 1977, in response to allegations of widespread manipulation in the market for exchange-traded options, the Commission initiated an investigation and special study of the options markets. The result of the Commission's investigation was The Report of the Special Study of the Options Markets, issued on December 22, 1978 (''Options Study''). Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. (Comm. Print No. 96–IFC3, December 22, 1978) (examining the major issues of market structure in standardized options markets, including multiple trading). In the Options Study, the Commission acknowledged that Congress had intended to include options in a national market system, and set forth a number of issues to be explored before the options markets could be fully integrated into the national market system. Options Study at 1029–1030. The Options Study delineated the following as among the issues to be explored in the options market: (1) A comprehensive quotation system for the dissemination of firm quotes; (2) market linkage and order routing systems to enable the best execution of orders; (3) nationwide limit order protection to ensure that agency orders receive auction-type trading protections; and (4) off-board trading restrictions. Subsequently, the Commission approved, pursuant to Section 11A of the Exchange Act and Rule 11Aa3–2 thereunder, a national market system plan that collects and disseminates consolidated quotes and trades for the options markets, the Options Price Reporting Authority (''OPRA'') Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information (''OPRA Plan''). See Securities Exchange Act Release No. 17638 (March 18, 1981).

[23] The Commission has repeatedly called for increased national market system initiatives in the options markets. See Securities Exchange Act Release No. 16701 (March 26, 1980), 45 FR 21426 (April 1, 1980) (deferring expansion of multiple trading to afford the options exchanges an opportunity to consider the development of market integration facilities); Securities Exchange Act Release No 22026 (May 8, 1985), 50 FR 20310 (May 15, 1985) (urging options market participants to consider the development of market integration facilities); Directorate of Economic and Policy Analysis, ''The Effects of Multiple Trading on the Market for OTC Options'' (November 1986); Office of the Chief Economist, ''Potential Competition and Actual Competition in the Options Market'' (November 1986); and Securities Exchange Act Release No. 26871 (May 26, 1989), 54 FR 24058 (June 5, 1989) (requesting comment on three measures, including an intermarket linkage). In 1989, the Commission adopted Exchange Act Rule 19c-5, which generally prohibits any exchange from adopting rules limiting its ability to list any stock options class because that options class is listed on another exchange. See Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963 (June 5, 1989). In 1990, then Chairman Breeden requested that the options exchanges develop an intermarket linkage plan. See letter from Chairman Breeden to the Registered Options Exchanges dated January 9, 1990.

[24] Id.

[25] In the equity markets, the ITS Plan includes a trade-through rule protecting displayed bids and offers for ITS-eligible exchange-listed securities. *See* Securities Exchange Act Release No. 17703 (April 9, 1981), 22 S.E.C. Doc. 707. In conformance with the ITS Plan, each participating exchange and the National Association of Securities Dealers (''NASD'') has adopted rules that limit trade-throughs in exchange-listed securities. *See* Securities Exchange Act Release No. 17704 (April 9, 1981), 46 FR 22520 (April 17, 1981). The NASD submitted a proposed trade-through rule for exchange-listed stocks, which the Commission approved on May 6, 1982. *See* Securities Exchange Act Release No. 18714, 47 FR 20429 (May 12, 1982). On June 21, 1985, the Commission requested comment on, among other things, the extent to which securities listed on The Nasdaq Stock Market, Inc. (''Nasdaq'') should be subject to trade-through rules. *See* Securities Exchange Act Release No. 22127 (June 21, 1985), 50 FR 26584 (June 27, 1985). In addition, in recently adopting amendments to the ITS Plan to expand the linkage to all listed securities, the Commission concluded that the NASD should continue to consider modifications to its existing trade-through rule to cover non-ITS participants, but that such modifications were not a precondition to approval of the expanded linkage. *See* Securities Exchange Act Release No. 42212 (December 9, 1999), 64 FR 70297 (December 16, 1999).

[26] *See* Securities Exchange Act Release No. 16701 (March 26, 1980), 45 FR 21426 (April 1, 1980) (''Moratorium Termination Release'').

[27] Exchange Act Rule 19c–5, 17 CFR 240.19c–5. *See* Securities Exchange Act Release No. 26870, *supra* note 23.

[28] The NYSE has since sold its options business to the CBOE. *See* Securities Exchange Act Release No. 38542 (April 23, 1997), 62 FR 23521 (April 30, 1997).

[29] The filing was amended on April 29, 1991, when the signatories to the Proposed Plan submitted a Model Option Trade-Through Rule as Exhibit A to the Proposed Plan (''Model Trade-Through Rule''). The Model Trade-Through Rule would have been incorporated into each of the options exchanges' rules. The Model Trade-Through Rule provided that, absent reasonable justification or excuse, a member in a participant market should avoid initiating a trade-through when purchasing or selling an options contract permitted to be transmitted through the proposed linkage.

[30] *See* Securities Exchange Act Release No. 30187 (January 14, 1992), 57 FR 2612 (January 22, 1992).

[31] The Phase-In Plan was put forth by the Securities Industry Association (''SIA'') and endorsed by the Committee on Options Proposals (''COOP''). *See* letters to Jonathan G. Katz, Secretary, SEC, from Thomas P. Hart, Chairman, SIA Options and Derivative Products Committee, dated March 10, 1992; and Michael Schwartz, Chairman, COOP, dated March 11, 1992.

[32] *Id. See also* letter from Richard C. Breeden, Chairman, SEC, to Alger B. Chapman, Chairman & CEO, CBOE, dated June 30, 1992 (setting forth the Commission's understanding of the elements of the Phase-In Plan).

[33] *See* Securities Exchange Act Release Nos. 34431, 34432, 34444, 34434, and 34435 (July 22, 1994), 59 FR 38994 (August 1, 1994) (orders approving proposed rule changes filed by Amex, CBOE, NYSE, Phlx, and PCX, respectively). *See also* Amex Rule 958A, Commentary 01; CBOE Rule 8.51(b); PCX Rule 6.37(d); Phlx Rule 1015(b); and ISE Rule 804.

in another market, because that quote need not be firm when reached. Thus, the trade-or-fade rules have done little to promote price priority or discourage intermarket trade-throughs. As described below, the rules adopted by the Commission today respond to changes in the options markets and reflect a different approach to limiting intermarket trade-throughs and promoting price priority.

B. Application of the Quote Rule in the Options Market

As a testament to the importance of firm quotes in the securities markets, one of the first national market system initiatives implemented by the Commission in the equity markets was the Quote Rule.[34] The Quote Rule requires all national securities exchanges and associations to establish procedures for collecting from their members bids, offers, and quotation sizes with respect to reported securities, and for making such bids, offers, and sizes available to quotation vendors. It also requires that quotation information made available to vendors be ''firm,'' subject to certain exceptions.

By its terms, the Quote Rule currently does not apply to options. At the time the Quote Rule was adopted in 1978,[35] standardized options had been listed and traded on the options exchanges for only a few years, and the Commission had imposed a moratorium that restricted the expansion of options trading.[36] For example, in 1980, when the Commission lifted the moratorium on options listings, it also set forth its vision on the future of options multiple trading, including the feasibility of firm quotes.[37] Successful implementation of a linkage among the markets was thought to depend upon the quality and reliability of quotation information disseminated by each market center. At that time, however, the Commission believed that the imposition of a firm quote requirement on the options markets and market participants was unworkable.[38]

In conjunction with the Commission's adoption in 1989 of Rule 19c-5 [39] relating to multiple trading of options, the Commission published a staff concept release that discussed options market structure issues associated with multiple trading, and outlined suggestions for possible market structure enhancements.[40] The release emphasized that the availability and reliability of comprehensive quotation information for options are important elements in considering the concerns traditionally associated with multiple trading.

The release discussed whether the then-existing quote and trade reporting mechanism for options needed to be adapted for multiple trading by requiring that equity options quotes be firm. Market participants had, in the past, argued against a firm quote requirement in the options markets for a number of reasons.[41] These concerns, however, were recognized as largely moot due to the development of autoquote [42] and automatic execution [43] systems, which indicated that firm quotes were, at the very least, possible.[44]

Today, each options market requires its market makers to have firm quotes for some types of orders. [45]Therefore, the Commission believes that imposing a market-wide firm quote obligation on options market participants should not be unduly burdensome. While the exchanges' firm quote rules and automatic execution systems provide their public customers with firm quote guarantees, these rules currently do not extend to other market participants. As described below, the amendments to the Quote Rule adopted by the Commission today require that options quotes be firm for broker-dealer orders for at least one contract.

III. Description of Proposed Rulemaking [46]

A. Proposed Trade-Through Disclosure Rule

In the Proposing Release, the Commission proposed new Rule 11Ac1–7 under the Exchange Act [47] to require a broker-dealer to disclose to a customer when the customer's order to buy or sell a listed option is executed at a price inferior to the best quote published at the time of execution of the customer's order. The proposal identified seven circumstances in which a trade executed at a price inferior to a published price on another market would, nevertheless, not be considered a trade-through for purposes of the

[34] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1. The reliability and availability of quotation information are basic components of a national market system and are needed so that broker-dealers are able to make best execution decisions for their customers' orders, and customers are able to make order entry decisions. *See* Securities Exchange Act Release No. 12670 (July 29, 1976), 41 FR 32856 (August 5, 1976) (proposing Exchange Act Rule 11Ac1–1).

[35] *See* Securities Exchange Act Release No. 14415 (January 26, 1978), 43 FR 4342 (February 1, 1978), as amended in Securities Exchange Act Release Nos. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); and 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

[36] *See supra* notes 21 and 22 and accompanying text.

[37] *See* Moratorium Termination Release, *supra* note 26.

[38] In 1980, quotes were updated manually; thus, the options exchanges argued that it would be virtually impossible for a market maker to update its quotes in a timely fashion each time the underlying stock price moved.

[39] *See* Securities Exchange Act Release No. 26870, *supra* note 23.

[40] *See* Securities Exchange Act Release No. 26871, *supra* note 23.

[41] One major concern of market participants was that due to the derivative nature of options, and the need to adjust quotes in numerous series in response to a single price change in the underlying security, it would be impossible, or at least impractical, to require options market makers to honor their disseminated quotes. Further, it was thought to be difficult for an exchange to identify which member of a trading crowd was responsible for a quote and to provide a mechanism for quotes to be modified or withdrawn.

[42] Autoquote systems enable options market professionals to update their quotes in numerous options series simultaneously.

[43] Automatic execution systems provide, in effect, firm quotes for public customer orders.

[44] *See* Securities Exchange Act Release No. 26871, *supra* note 23.

[45] *See generally* Amex Rule 958A (requiring a specialist to sell/buy at least 10 contracts at the offer/bid displayed when the order reaches the trading post); CBOE Rule 8.51 (generally requiring a trading crowd to sell/buy at least the RAES contract limit applicable to a particular options class at the offer/bid displayed when a customer order reaches the trading station); PCX Rule 6.86 (generally requiring a trading crowd to provide a depth of 20 contracts for all non-broker-dealer orders at the bid/offer disseminated at the time an order is announced at the trading post); Phlx Rule 1015 (requiring that public customer orders be filled at the best market for a minimum of 10 contracts); and ISE Rule 804 (requiring a market maker to enter the number of contracts it is willing to buy or sell at its quote and prohibiting a market maker from entering a bid or offer for less than 10 contracts).

[46] In response to the Proposing Release, the Commission received comment letters from fourteen commenters representing the views of four exchanges, seven firms, and four other interested parties. *See* letters to Jonathan G. Katz, Secretary, SEC, from Samuel F. Lek, Chief Executive Officer, Lek Securities Corporation, dated September 20, 2000 (''Lek Letter''); Michael J. Simon, Senior Vice President and Secretary, ISE, dated September 18, 2000 (''ISE Letter''); George Brunelle, Brunelle & Hadjikow, dated September 15, 2000 (''Brunelle Letter''); Juan Carlos Pinilla, Managing Director, J.P. Morgan Securities, Inc. (''JPMorgan Letter''); Thomas A. Bond, CBOE, dated October 9, 2000 (''CBOE Letter''); Phillip D. DeFeo, Chairman and Chief Executive Officer, PCX, dated October 10, 2000 (''PCX Letter''); Michael G. Vitek, President, Botta, dated September 29, 2000 (''Botta Letter''); Joel Greenberg, Managing Director, Susquehanna Investment Group, dated September 22, 2000 (''Susquehanna Letter''); Chris Delzio, Amex Member, dated August 15, 2000 (''Delzio Letter''); Lewis Singletary, Journeyman Holdings Corporation, dated September 30, 2000 (''Singletary Letter''); Meyer S. Frucher, Phlx, dated September 18, 2000 (''Phlx Letter''); Edward Provost, Executive Vice President, Business Development Division, CBOE, dated September 13, 2000 (asking for an extension of the comment period); Robert Bellick, Co-Managing Partner, Wolverine Trading, L.L.P., dated October 25, 2000 (''Wolverine Letter''); Robin Roger, Managing Director and Counsel, Morgan Stanley Dean Witter, dated October 25, 2000 (''Morgan Stanley Letter''); and William McGowen, Chairman, Options Committee, SIA, dated October 31, 2000 (''SIA Letter'').

[47] *See* Proposing Release, *supra* note.

rule.[48] In addition, as an incentive for markets to cooperate in developing effective means to access the quotes of other markets to avoid intermarket trade-throughs, the Commission's proposal excepted broker-dealers from the proposed disclosure requirements if they effected their customer orders on options markets that participated in an intermarket linkage plan approved by the Commission that had provisions reasonably designed to limit intermarket trade-throughs.

B. Proposed Amendments to the Quote Rule

The Commission also proposed to amend Exchange Act Rule 11Ac1–1 to require options exchanges and options market makers to publish firm quotes.[49] Because OPRA currently does not have the ability to collect from the exchanges and disseminate to quotation vendors size information, the Commission proposed to amend the Quote Rule so that broker-dealers would not be required to communicate, and options exchanges would not be required to collect and make available on a quote-by-quote basis, the size associated with each quotation in listed options. Instead, an options exchange would be required to establish by rule and periodically publish the size for which its best bid or offer in each options series that is listed on the exchange is firm. If, however, an exchange does collect quotations with size from its broker-dealers, it would have to make such information available as currently required under the rule.[50]

In addition, the Commission proposed two alternatives relating to the flexibility an exchange would have to establish the size for which its quotes were firm for different types of orders. Specifically, under proposed Alternative A, the size for which an exchange's best bid or offer is firm would have to be the same for orders received from customers as for orders received from broker-dealers. Under proposed Alternative B, however, an exchange could allow market makers to establish different firm quote sizes for broker-dealer orders and for customer orders.

Finally, the Commission proposed to require a responsible broker or dealer to respond to an order within 30 seconds by either executing the entire order or executing at least that portion of the order equal to its applicable firm quote size and revising its quote.

IV. Discussion

A. Trade-Through Disclosure Rule

After carefully reviewing the comment letters, the Commission has decided to adopt the Trade-Through Disclosure Rule, with several modifications from the proposal. Under this rule, a broker is required to disclose to its customer when the customer's order for listed options is executed at a price inferior to a better published quote, and to disclose the better published quote available at that time.[51] This disclosure must be made to the customer in writing at or before the completion of the transaction,[52] and may be provided in conjunction with the confirmation statement routinely sent to investors. Such disclosure must be displayed as prominently as the transaction price disclosed to the customer.

The Trade-Through Disclosure Rule provides, however, that a broker-dealer is not required to disclose to its customer an intermarket trade-through if the broker-dealer effects the transaction on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price.[53] In addition, broker-dealers will not be required to provide the disclosure required by the Trade-Through Disclosure Rule if the order is executed as part of a block trade.[54]

A number of commenters supported the Commission's proposal to require broker-dealers to disclose trade-throughs.[55] In particular, one commenter believed that intermarket trade-throughs virtually would be eliminated if a broker-dealer were required to disclose to a customer that an order was executed at a price that was inferior to the best-published quote.[56] Another commenter disagreed with this view, however, stating that the imposition of a disclosure requirement would not have a significant impact on the frequency of intermarket trade-throughs.[57]

In addition, several commenters noted that the disclosure required by the Trade-Through Disclosure Rule would never need to be made by broker-dealers if all exchanges join the Linkage Plan.[58] The Commission notes, however, that under the current terms of the Linkage Plan, any participant may withdraw from the plan with 30 days prior written notice to each of the other plan participants and the facilities manager, if any.[59] In addition, there may be new options exchanges entering the market in the future and those exchanges may decide not to participate in the Linkage Plan or any other intermarket linkage plan approved by

[48] The seven exceptions to the proposed definition of a trade-through included when: (1) The market publishing the better price was experiencing systems problems, which made the quote inaccessible; (2) OPRA was experiencing queuing; (3) the market publishing the better price was experiencing unusual market conditions; (4) the market showing the better price was in a trading rotation; (5) the customer order was executed as part of a trading rotation in that options class; (6) the customer order was executed as part of a complex trade; or (7) the market publishing the better quote fails to respond to an order routed to it within 30 seconds of receiving the order. *See* Proposing Release, *supra* note.

[49] *See* Proposing Release, *supra note*.

[50] As noted above, OPRA does not have the capability to collect size information from the options exchanges, but it anticipates implementing systems changes to accommodate quotes with size in January 2001.

[51] Exchange Act Rule 11Ac1–7(b)(1), 17 CFR 240.11Ac1–7(b)(1). The Commission believes that a broker-dealer should be allowed to rely on the market of execution to notify the broker-dealer when a trade-through has occurred and the best quote available at that time. One commenter suggested that the Trade-Through Disclosure Rule require that exchanges provide all relevant information to the broker-dealers, including a determination of whether a trade-through has occurred. See Morgan Stanley Letter. The Commission does not believe it is necessary at this time to impose such a requirement and expects that an exchange that does not participate in a linkage plan will have strong incentives to provide a broker-dealer executing orders on its market with any information the broker-dealer needs to comply with disclosure obligations.

[52] The term ''completion of the transaction'' in the Trade-Through Disclosure Rule shall have the meaning provided in Exchange Act Rule 15c1–1(b)(1), 17 CFR 240.15c1–1(b)(1). Exchange Act Rule 11Ac1–7(b), 17 CFR 11Ac1–7(b).

[53] Exchange Act Rule 11Ac1–7(b)(2)(i), 17 CFR 240.11Ac1–7(b)(2)(i). The Trade-Through Disclosure Rule also provides the Commission with the authority to exempt any broker or dealer from the requirements of the rule. Exchange Act Rule 11Ac1–7(c), 17 CFR 240.11Ac1–7(c).

[54] Exchange Act Rule 11Ac1–7(b)(2)(ii), 17 CFR 240.11Ac1–7(b)(2)(ii). The Commission sought comment on whether broker-dealers should be excepted from the trade-through disclosure requirement if they systematically route customer orders on an order-by-order basis to the exchange with the best price at the time the order is routed. Only one commenter addressed this issue, noting that simply routing orders to an exchange displaying the best price at the time the order is routed is not sufficient because of variances in the national best bid and offer (''NBBO''), the possibility that the receiving market does not offer trade-through protection, or the possibility of price improvement. At this time, the Commission has decided not to provide broker-dealers with an exemption from the disclosure requirements of the Trade-Through Disclosure Rule on this basis.

[55] *See* Lek Letter; PCX Letter; JPMorgan Letter; and ISE Letter.

[56] *See* Lek Letter.

[57] *See* CBOE Letter.

[58] See JPMorgan Letter; ISE Letter; CBOE Letter; Phlx Letter; and Wolverine Letter. Another commenter argued that the focus of the Commission and the options industry should be on preventing the occurrence of intermarket trade-throughs by moving ahead aggressively on implementing the Linkage Plan, rather than by disclosing intermarket trade-throughs to investors after the fact. See SIA Letter.

[59] See Linkage Plan, Section 12.

the Commission. Moreover, as discussed further below, the Linkage Plan approved by the Commission must still be amended before the Commission would consider it to be reasonably designed to limit intermarket trade-throughs and, therefore, satisfy the exception from trade-through disclosure. Therefore, the Commission continues to believe that the Trade-Through Disclosure Rule is needed to ensure that, if the exchange on which their orders are executed does not belong to an approved linkage plan designed to limit intermarket trade-throughs, investors receive disclosure when their orders are not executed at the best price.

It is an important feature of the Trade-Through Disclosure Rule adopted today that it does not prohibit intermarket trade-throughs. At times, investors may value speed, size, or liquidity over price. By not prohibiting intermarket trade-throughs, the rule permits investors to achieve their goals and provides them with information that will facilitate their ability to actively monitor whether the quality of executions they receive is satisfactory.[60] Therefore, the Commission believes that the rule will help to ensure that the decision not to pursue publicly-displayed, superior prices is rooted in the interests of customers, not that of intermediaries. In addition, the Commission believes that in the absence of direct linkages, the rule will encourage broker-dealers to develop effective means of accessing better quotes published by other markets and thereby, avoid intermarket trade-throughs.[61]

1. Minimum Requirements for Linkage Plans

The Trade-Through Disclosure Rule excepts from its requirements any broker-dealer that executes customer orders on exchanges that participate in an intermarket linkage plan that is reasonably designed to limit intermarket trade-throughs. The Commission believes that to be reasonably designed to limit intermarket trade-throughs, a plan should contain, at a minimum, provisions to: (1) Limit participants from trading through, not only the quotes of other linkage plan participants, but also, the quotes of exchanges that are not participants in an approved linkage plan; (2) require plan participants to actively surveil their markets for trades executed at prices inferior to those publicly quoted on other exchanges; and (3) make clear that the failure of a market with a better quote to complain within a specified period of time that its quote was traded-through may affect potential liability, but does not signify that a trade-through has not occurred. Accordingly, the Linkage Plan must be amended before broker-dealers effecting transactions on exchanges participating in the plan would be excepted from the disclosure requirements of the Trade-Through Disclosure Rule.[62] The Commission does not agree that these modifications to the Linkage Plan would add significant costs without adding significant additional deterrence to intermarket trade-throughs, as stated by one commenter,[63] and believes that the minimum requirements are important factors to consider in assessing whether a linkage plan is ''reasonably designed to limit trade-throughs'' and therefore, vitiate the need for broker-dealers to provide disclosure to their customers.

The Commission requested comment on what provisions a linkage plan should include and whether the minimum factors set forth above are sufficient. In particular, the Commission asked for comment on whether, instead of requiring that a linkage plan limit intermarket trade-throughs of the quotes disseminated by markets that do not participate in an approved linkage plan, a linkage should only be required to limit intermarket trade-throughs of markets that participate in an approved linkage plan. In this regard, one commenter asserted that the Commission should not require a linkage plan to protect against trading through those markets that are not participants of the same linkage plan because those markets would be difficult to access effectively. This commenter noted that a linkage plan provides an efficient and almost instantaneous means by which one exchange participating in the plan can access another exchange participating in the plan, as well as minimum size guarantees for orders routed through the linkage, and therefore, assures customers and dealers access to the best bid or offer. In contrast, for markets that do not participate in the linkage plan, the lack of effective access simply increases the time needed to execute a customer order without any corresponding guarantee of execution.[64]

Other commenters, however, supported the notion that a linkage plan must provide some form of protection against trading through any exchanges that do not participate in the linkage plan.[65] One of the commenters stated that options exchanges should adopt reasonable rules and procedures to address trade-throughs of markets that do not participate in an approved linkage plan because, to instill investor confidence in the options market, there must be the same basic protections against trade-throughs as are available in the equity market.[66] Another commenter argued that firms that do not execute transactions on an exchange that participates in a linkage plan should be required to disclose intermarket trade-throughs of both participant and non-participant markets, particularly in light of the possibility that a market could opt out of the plan.[67]

In proposing this rule, the Commission recognized that, by providing an incentive for markets to cooperate in developing effective means to access other markets, intermarket trade-throughs would be minimized. However, the value of the Trade-Through Disclosure Rule would be greatly diminished to the extent that: (1) One or more options exchanges decide not to participate in an approved linkage plan; (2) intermarket trade-throughs were not minimized by the implementation of a linkage plan because the plan fails to provide protection across all markets, including markets that do not participate in the linkage plan; (3) away markets fail to complain about intermarket trade-throughs; or (4) market makers or specialists were not subject to potential sanctions for intermarket trade-throughs. Accordingly, the Commission believes that to provide sufficient

[60] One commenter contended that the proposal would do nothing to improve the transparency of execution quality. *See* Wolverine Letter. The Commission disagrees with this assertion. Although the disclosures about execution quality adopted today for the equity markets provides much more information to investors than the Trade-Through Disclosure Rule does, the Commission believes that, before execution quality disclosures could be required for options trading, potentially difficult issues, such as the absence of a consolidated NBBO in the options market, would have to be resolved. *See* Securities Exchange Act Release No. 43590 (November 17, 2000).

[61] The Commission notes, however, that the Trade-Through Disclosure Rule does not replace the well-established duty that brokers provide best execution to their customers. To the contrary, brokers remain obligated to seek the most favorable terms possible under the circumstances for their customers. *See supra* note.

[62] In addition, to comply with these standards, an exchange participating in a linkage would have to adopt rules to allow the exchange to sanction specialists or market makers that trade through better prices of other exchanges, maintain policies and procedures that would limit the occurrence of intermarket trade-throughs, and maintain records that would identify intermarket trade-throughs and any review or remedial action taken by the exchange in response to such intermarket trade-throughs.

[63] *See* JPMorgan Letter.

[64] *See* CBOE Letter.

[65] *See* ISE Letter and Phlx Letter.

[66] *See* ISE Letter.

[67] *See* Phlx Letter.

incentives to markets to avoid intermarket trade-throughs under the Trade-Through Disclosure Rule, an intermarket linkage plan must contain the provisions described above provide broker-dealers executing orders on markets participating in the plan with an exception to the disclosure requirements of the rule. Specifically, the Commission believes that to maintain the integrity and value of a Trade-Through Disclosure Rule, a linkage plan must provide protection against orders trading through the quotes of all markets, regardless of whether that market participates in the plan. However, to allow the options exchanges to retain greater flexibility, the Commission is not mandating participation in a particular intermarket linkage plan.

2. Mandatory Participation in a Linkage Plan

The Commission also sought comment on whether it should order the options exchanges to become participants in the Linkage Plan or any other intermarket linkage plan. In response, several commenters expressed their view that the proposed Trade-Through Disclosure Rule was a vehicle to compel options exchanges to join an intermarket linkage plan,[68] and one argued that the Commission should directly require all options exchanges to become participants in a qualified linkage plan rather than ''creating a disclosure-based exception that accomplishes *de facto* the same result.'' [69] Another commenter, however, expressly stated that it did not believe that participation in a single linkage plan should be mandatory. This commenter concurred with the Commission's contention in the Proposing Release that a single linkage may fail to adapt over time and may impede the entry of new market participants.[70]

The Commission intends for the intermarket linkage plan exception to the Trade-Through Disclosure Rule to encourage options markets to participate in a Commission-approved intermarket linkage plan. In fact, all five options exchanges are now participants in the Linkage Plan.[71] However, at this time, the Commission continues to be reluctant to force, by government mandate, all options exchanges to participate in a single linkage system that may, for example, fail to maintain up-to-date technology. The Commission believes that, in the absence of barriers to access, the growth of electronic order-routing systems may enable the options exchanges to access one another's markets directly through agreed-upon methods, or indirectly through broker-dealers. As a result, the Commission continues to believe that, given effective access, there may well be a variety of equally effective, or more effective, ways in which technology may be employed by the markets to encourage price priority and decrease the likelihood of intermarket trade-throughs in the options markets. Consequently, rather than mandating exchange participation in any one linkage plan, the Commission is adopting the more flexible approach, as proposed, that provides incentives for the markets and their members to develop mechanisms to reduce the frequency of intermarket trade-throughs, while allowing market participants to choose the form of mechanism employed.

3. Exception From Disclosure Requirement for Block Trades

Finally, in response to comments, the Commission is adopting an exclusion from the trade-through disclosure requirement for block trades.[72] The Commission sought comment on whether to except block trades from the trade-through definition because of their size in relation to the quote, their special handling needs, and the greater resources of customers placing block orders to monitor the quality of executions they receive. Two commenters specifically supported such an exception.[73]

For ease of administration, the Commission has adopted, in part, the definition of ''block trade'' used in the Linkage Plan,[74] which was developed by the options exchanges. Because a block trade would involve 500 contracts or more and a premium value of at least $150,000, the Commission anticipates that only highly sophisticated investors will place such trades. Moreover, as noted by commenters, because of the size of these block orders, market participants placing such orders do not necessarily expect execution of the full order at the best-quoted price.[75] As a result, the Commission believes that the value of a trade-through disclosure for market participants placing such orders likely would be minimal.

4. Definition of Trade-Through

The Commission is adopting the definition of a trade-through and the exceptions to the definition of a trade-through, substantially as proposed. Specifically, a trade-through occurs when a customer order is executed at a price inferior to a quote published by another market at the time of execution.[76] The rule also identifies four circumstances in which a trade executed at a price inferior to a published price on another market would, nevertheless, not be considered a trade-through for purposes of the rule.[77]

a. OPRA Delays. Because a broker-dealer should not be required to disclose to its customer that its order was executed at a price inferior to a ''stale'' quote, a trade will not be considered a trade-through if it occurs while OPRA is experiencing queuing.[78] In the past, the aggregate message traffic generated by the options exchanges has, at times, surpassed OPRA systems capacity, which could result in the dissemination of quotes that are no longer accurate or accessible.

b. Systems Malfunctions. Similarly, the Commission believes that it is appropriate to exclude from the definition of trade-through trades that are executed at a time when an exchange has verified that the market publishing the better price was experiencing systems malfunctions, thus resulting in inaccessible quotes.[79] For example, this may occur when a broker-dealer has attempted to access the superior published quote and has been unsuccessful because of systems

[68] *See* ISE Letter; Phlx Letter; and CBOE Letter.

[69] *See* CBOE Letter.

[70] *See* PCX Letter. On the other hand, another commenter expressed concern that a disclosure-based approach to creating incentives for markets to link will not be as effective in fostering quote and order competition and interaction as a direct Commission role in mandating a universal linkage. *See* Morgan Stanley Letter. The Commission is not, however, attempting to foster quote and order interaction by adopting the Trade-Through Disclosure Rule, but is, instead, trying to achieve the more limited goal of reducing the possibility for investors' orders to be executed at a price inferior to the best available price.

[71] *See supra* notes 4 and 5.

[72] Exchange Act Rule 11Ac1–7(b)(2)(ii), 17 CFR 240.11Ac1–7(b)(2)(ii). The term ''block trade'' is defined as a transaction in an options series that is for 500 or more contracts and has a premium value of at least $150,000. Exchange Act Rule 11Ac1–7(a)(1), 17 CFR 240.11Ac1–7(a)(1).

[73] *See* JPMorgan Letter and SIA Letter.

[74] *See* Linkage Plan, Section 2 (3).

[75] *See* JPMorgan Letter and SIA Letter. One of these commenters noted that with respect to block-sized orders, the quote bears ''little relationship to the average price that the customer could get for the entire order.'' *See* JPMorgan Letter. The other of these commenters argued that ''because large orders are far more dependent on liquidity than smaller orders, the ability to get a block off on a timely, efficient basis may be severely impacted by strict adherence to a trade-through rule.'' *See* SIA Letter.

[76] Exchange Act Rule 11Ac1–7(b)(3), 17 CFR 240.11Ac1–7(b)(3).

[77] Exchange Act Rule 11Ac1–7(b)(4), 17 CFR 240.11Ac1–7(b)(4).

[78] Exchange Act Rule 11Ac1–7(b)(4)(ii), 17 CFR 240.11Ac1–7(b)(4)(ii).

[79] Exchange Act Rule 11Ac1–7(b)(4)(i), 17 CFR 240.11Ac1–7(b)(4)(i).

problems in the quoting market. The Commission believes that there is no value in requiring a broker-dealer to disclose an inability to access a market's quote that has been verified as inaccessible.

c. Relief from Firm Quote Obligation. The definition of trade-through also excludes a trade executed at a price inferior to a price published by another exchange if the other exchange or its members were relieved of their obligations under the Quote Rule because the exchange has determined, for example, that, as a result of unusual market conditions,[80] it is incapable of accurately collecting and disseminating quotes.[81]

One commenter recommended that the Commission provide brokers with discretion to interpret the exceptions broadly in light of their duty of best execution, instead of forcing a broker to incur the risk of subsequently providing an inferior price to a public customer against its better judgment. This commenter argued that a broker should have discretion to ''use the 'unusual market circumstances' exception to refuse to route a trade to an exchange that has a history of disseminating 'flickering' quotes, rather than being forced to disclose to the customer a trade-through of a phantom 'better' price that, in all likelihood, never existed.'' [82]

The Commission agrees that brokers must always consider their best execution obligations to their customers.[83] The Trade-Through Disclosure Rule does not prohibit intermarket trade-throughs; it merely requires a firm to provide information to its customer about the market at the time of execution. Therefore, the Commission does not agree that broker-dealers should be granted discretion to avoid disclosure if they trade through another market quote because of their discomfort with the quality of that market's quote. While the Commission appreciates the commenter's concerns regarding ''flickering quotes,'' the Quote Rule amendments adopted today are designed to address this issue by requiring that disseminated quotes be firm up to the applicable firm quote size.

d. Thirty-Second Delay. In addition, the Trade-Through Disclosure Rule excludes from the definition of trade-through a trade that occurs after an exchange member attempts to access a better-published quote for a customer order and the market publishing the better quote fails to respond to the order routed to it in a timely fashion.[84]

Although one commenter contended that the Commission should not adopt this exception to the definition of a trade-through because it condones the actions of a market maker who simply ignores an incoming customer order that is unfavorable or inconvenient,[85] the Commission believes that a broker-dealer should not be obligated to disclose a trade-through in the event that an exchange member attempted to access a better published quote for a customer order, but the market publishing the better quote failed to respond to the order routed to it within 30 seconds of receiving the order. In this instance, the exchange member has attempted to access the superior published quote and has been unsuccessful. The Commission believes that the originating broker-dealer should not be obligated to provide the disclosure when the member of another exchange has failed to satisfy its obligations under the Quote Rule. In addition, the Commission believes that there is no value in requiring an exchange member to repeatedly attempt to access an inaccessible quote, especially in a volatile market where substantial delays may result in far inferior executions for the investor. Further, the Commission believes that the amendments to the Quote Rule adopted today will ensure that responsible broker-dealers honor their quotes up to the size for which they are required to be firm, and expects exchanges to surveil their members to ensure compliance with the amended Quote Rule.

e. Trades Not Excluded from the Definition of Trade-Through. In the Proposing Release, the Commission sought comment on whether a trade-through disclosure requirement should apply to all trade-throughs, or only when an order is executed at a price that trades through a better price by a certain price increment or amount. The Commission noted that this question is particularly important in a decimals trading environment, where quotes may be for a smaller size and the trade-through price for smaller increments, and with respect to large orders, where the quote size may be small in relation to the order size.

Several commenters supported such a ''materiality'' standard.[86] For example, one commenter argued that all orders would benefit, regardless of size, from an exception to the disclosure requirement for trade-throughs of price increments immaterial in relation to the spread. This commenter believed that any trade-though disclosure should include the size of the traded-through quote, but that a materiality exception would be preferable to disclosure of the size of the quote, because such size disclosure would be more costly for market participants, including customers.[87] Another of these commenters believed the disclosure requirement should not apply if the price and size of the trade-through was *de minimus*. Although this commenter did not define *de minimus*, the commenter argued that given the imminent conversion to decimal pricing, the burdens of disclosing when an order trades through a quote that is better by a very small amount or is only for a small size would not be justified.[88] On the other hand, one commenter opposed adopting a *de minimus* exception to the trade-through definition due to the inherent difficulty in defining what constitutes *de minimus*, and the possibility that opportunities for the unbundling of orders to avoid trade-though liability would be created.[89]

The Commission believes that it is inappropriate at this time to attempt to establish a materiality standard. The Commission notes that, as of September 25, 2000, only 36 options are trading in decimals. As a result, the Commission does not believe that it, the options exchanges, or other market participants has had sufficient experience with a decimals environment. The Commission notes, however, that it will continue to evaluate this issue as decimal pricing is expanded to all options classes and the markets adapt to the decimals environment.

---

[80] Exchange Act Rule 11Ac1–1(b)(3), 17 CFR 240.11Ac1–1(b)(3). Currently, each options exchange has rules that allow the exchange to suspend its firm quote requirements if, for example, a systems malfunction or other circumstance impairs the exchange's ability to disseminate or update market quotes in a timely and accurate manner. *See* Amex Rule 958A; CBOE Rule 8.51(a); PCX Rule 6.86(d); Phlx Rule 1015(a)(ix); and ISE Rule 804(d). The options exchanges may have to amend these rules to conform to the Quote Rule's exception for unusual market conditions.

[81] Exchange Act Rule 11Ac1–7(b)(4)(iii), 17 CFR 240.11Ac1–7(b)(4)(iii).

[82] *See* JPMorgan Letter.

[83] *See supra* note 2. One commenter asserted that under the Commission's proposal, brokers would no longer have to make best execution evaluations. *See* Wolverine Letter. The Commission strongly disagrees with this view and expects brokers to continue to fulfill their obligations to seek the most favorable terms reasonably available under the circumstances for a customer's order.

[84] Exchange Act Rule 11Ac1–7(b)(4)(iv), 17 CFR 240.11Ac1–7(b)(4)(iv).

[85] *See* Brunelle Letter. Another commenter, however, supported this proposed exception. *See* ISE Letter.

[86] *See* JPMorgan Letter; CBOE Letter; and PCX Letter.

[87] *See* JPMorgan Letter.

[88] *See* PCX Letter.

[89] *See* CBOE Letter.

In addition, a few commenters recommended that the trade-through disclosure requirement not be applied to orders from upstairs broker-dealers and orders of customers who consent to the potential for an execution at an inferior price.[90]

Because upstairs broker-dealers' orders are not eligible to be transmitted through the linkage pursuant to the Linkage Plan, one commenter argued that broker-dealers should not be required to disclose an execution at a price inferior to the best price. [91] The Commission notes that the trade-through disclosure requirement would not require disclosure to upstairs broker-dealers because it only applies when a broker-dealer executes a non-broker-dealer order.

A commenter also recommended including an exception for trades of customers who request that their orders be executed on a particular market, regardless of whether a better price is available on another market. This commenter contended that a customer may give such consent because of its greater interest, for example, in the speed of execution. [92] Another commenter suggested an exception for when customers provide instructions to route, or avoid routing, their orders to a particular exchange, irrespective of price. [93]

The Commission does not believe that it is appropriate to except broker-dealers from the requirement to disclose a trade-through to its customer even when a customer requests that its order be executed on a particular market, regardless of price. While one commenter suggested that a trade-through disclosure to a customer that has explicitly requested an execution at an inferior price may be superfluous, the Commission is concerned that the adoption of such an exception may result in broker-dealers entering into blanket adhesion contracts with customers, solely to allow the broker-dealer to execute order flow on a particular options exchange even though that exchange does not provide the best price. [94] The Commission believes that such an exception would raise investor protection concerns, particularly with respect to unsophisticated investors who may not fully appreciate the impact of the agreement and may lack the ability to negotiate preferable terms. In addition, the Commission believes that in those instances where a customer has expressed a desire to have its order executed on a particular exchange regardless of a better published price available on another market, the customer will not perceive the disclosure of a trade-through as problematic.

Finally, the Commission's definition of a trade-through also includes transactions executed as part of a complex trade. Although the Commission proposed to exclude complex trades, which were defined as transactions in an option series that are executed in conjunction with related transactions occurring at or near the same time for the purpose of executing a particular investment strategy, [95] the Commission now believes that such an exclusion is not appropriate. [96] On further consideration, the Commission has determined that such disclosure is important, even to customers executing more complex trades. Because retail customers use these types of investment strategies, information about the execution price relative to other prices may be invaluable to their understanding and decision-making. Even the most sophisticated investors may find this information useful.

5. Compliance Date

The Trade-Through Disclosure Rule will become effective on February 1, 2001, and its compliance date is April 1, 2001. On April 1, 2000, broker-dealers will be required to make the required disclosures unless their transactions are effected on markets that are participants in an effective national market system options linkage plan that includes provisions reasonably designed to limit intermarket trade-throughs. The Commission believes that a linkage plan is not reasonably designed to limit intermarket trade-throughs unless it has been implemented and is operating. While one commenter expressed its view that the Commission should not require compliance with the Trade-Through Disclosure Rule until the Linkage Plan has been implemented, [97] the Commission is concerned that tying the compliance date to this event may provide a disincentive for the options markets to fully implement the Linkage Plan. Accordingly, the Commission does not, at this time, believe that it is necessary to delay the compliance date of this rule until the linkage is fully implemented and operating. The Commission will consider granting temporary exemptive relief to broker-dealers from the requirements of the rule if the markets continue to make substantial progress towards implementing the Linkage Plan.

B. Amendments to the Quote Rule

As discussed above, the Commission is adopting amendments to the Quote Rule to extend its application to options traded on national securities exchanges. Generally, the Quote Rule requires exchanges to collect quotations, and sizes associated with those quotations, from their members who are responsible broker-dealers and make those quotations and sizes available to quotation vendors for each subject security listed and admitted to unlisted trading privileges on the exchange. [98]

The Commission received several comment letters addressing the proposed Quote Rule amendments. A number of commenters voiced their support for amending the Quote Rule to include listed options, [99] stating, for example, that firm quotes will promote efficiency and increase customer confidence in the markets. [100] One commenter noted that the lack of such a rule in the options markets impeded firms' ability to execute customer orders in an efficient manner because they have to explore posted quotes to determine if a quote is firm for an entire order or only for an order of minimal size. [101]

Other commenters, however, opposed the proposed amendments to the Quote Rule. [102] Two of these commenters argued that the current exchange rules and exchange automatic execution systems sufficiently guarantee firm quotes to public customers. Thus, they contended that amending the Quote Rule would simply extend its application to broker-dealer orders, a result they opposed. [103] One commenter noted that current competition among market makers for public customer

[90] *See* PCX Letter and Brunelle Letter.

[91] *See* PCX Letter

[92] *See* PCX Letter.

[93] *See* Brunelle Letter.

[94] Payment for order flow and other similar arrangements increase the likelihood that such contracts could become commonplace.

[95] *See* Proposing Release, *supra* note 7.

[96] One commenter recommended narrowing the proposed definition of complex trades to exclude certain investment strategies that include stock trades, such as "buy-writes," in which an investor buys stock and writes a call on that stock. *See* ISE Letter. The Commission believes, however, that other strategies, such as spreads (the simultaneous purchase or sale of options on the same underlying stock with different strike prices or expiration dates or both) and straddles (simultaneous purchase and sale of an equal number of calls and puts on the same underlying security with identical strike prices and expiration dates), are sufficiently similar to buy-writes to warrant similar treatment.

[97] *See* PCX Letter.

[98] Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

[99] *See* JPMorgan Letter; ISE Letter; PCX Letter; Lek Letter; Wolverine Letter; and SIA Letter.

[100] *See* Lek Letter and PCX Letter.

[101] *See* JPMorgan Letter.

[102] *See* Botta Letter; Susquehanna Letter; Brunelle Letter; and Phlx Letter.

[103] *See* Botta Letter and Susquehanna Letter.

orders is intense, and believed that the proposed amendments would force allocation of capital into areas of unacceptable risk, such as trading against other broker-dealers, and away from the facilitation of public customer orders. [104]

The Commission has carefully considered the issues raised by commenters and believes it is appropriate to adopt amendments to the Quote Rule to extend its application to the options markets. The Commission, however, has made accommodations for the way in which the options markets operate. The Commission believes that the amendments will provide significant and immediate benefits to investors. In particular, market participants, including customers and broker-dealers, will be able to rely on quotes up to their published size in routing orders that are not eligible for execution in the automatic execution systems. The Commission believes that this result should lead to increased competition on the basis of size among the options exchanges, which should enable investors to receive better executions for their orders. It will also enable market makers and other broker-dealers to more easily trade with displayed quotes, increasing the accuracy and efficiency of displayed quotes.

As noted above, the availability of quotation information is one of the key components of a national market system. While options quotation information is provided to market participants today through OPRA, the Commission believes that this information will be substantially enhanced by the amendments to the Quote Rule. Quotes are not useful to market participants if they are not honored. Further, because market participants will be required to disclose trade-throughs of superior quotes (unless an exception applies), these superior quotes must be firm for all market participants, including broker-dealers. Otherwise, the Trade-through Disclosure Rule would be unworkable, and market makers would be forced to either route customers' orders to anomalous quotes, or unwillingly match that quote to avoid trade-through disclosure. The Commission believes that requiring options quotes to be firm furthers the national market system goals of Section 11A [105] and will benefit all options market participants.

Because of developments in technology and changes in the options markets, the Commission also believes that the current exchange rules and automatic execution systems alone are no longer sufficient to provide adequate investor protections. Currently, the options markets are permitted to fade from their quotes without consequence, pursuant to their trade-or-fade rules.[106] In addition, as noted by one commenter, options market makers frequently change the terms of trades or ''break'' trades subsequent to execution, without prior notice to the customer.[107] Thus, options investors and their brokers cannot fully rely on the disseminated quotation information on which they base their order routing decisions. The Commission believes that options investors deserve the same protections as equity investors and therefore, the Commission is adopting amendments to extend the coverage of the Quote Rule to the options market with modifications to accommodate certain unique aspects of the options market. The Commission also believes that a market maker that executes a trade at its disseminated quote and then changes the terms or ''breaks'' the trade may well, absent exceptional circumstances, be in violation of the firm quote obligation adopted today.

1. Collecting and Making Available Quotation Sizes

Because the options markets currently do not disseminate to quotation vendors the size associated with their bids and offers [108] and due to the existing limitations on OPRA system capacity, the Commission is adopting amendments to the Quote Rule so that options exchanges may decide not to collect from their members and make available to vendors the size associated with each quotation in listed options. Instead, exchanges may choose to establish by rule and periodically publish the size for which their best bid and offer in each options series [109] that is listed on the exchange is firm. [110] If the rules of an exchange do not require its members to communicate to it quotation sizes for listed options, then responsible brokers or dealers that are members of that exchange will be relieved of their obligations under the Quote Rule to communicate to such exchange their quotation sizes. Instead, each such responsible broker or dealer may satisfy its firm quote obligation by executing any order to buy or sell a listed option that is a subject security, in an amount up to the size established by the exchange's rules. [111] An options exchange may, of course, choose to establish procedures for collecting from its members, and making available to vendors, the sizes of such members' quotes.

The Commission is not adopting the recommendation of a few commenters that exchanges be required to disseminate quotation sizes as soon as OPRA is capable of doing so. [112] One commenter raised the concern that the proposed amendments to the Quote Rule would result in each exchange using its portion of OPRA bandwidth differently, which could benefit exchanges that show relatively limited size information, and have a significant adverse effect on exchanges that collect and disseminate the ''real'' size of their trading interest. [113] This commenter suggested that the Commission use its exemptive authority under the Quote Rule to require all exchanges to disseminate size with their quotations, even if an exchange determines to establish by rule and periodically publish its firm quote size.

Another commenter, while also acknowledging OPRA capacity constraints, argued that the concept of the periodic publication of firm quote sizes is contrary to OPRA's plan to require the dissemination of size with every options quote by January 2001. [114] Thus, this commenter believed that the

[104] *See* Susquehanna Letter.

[105] 15 U.S.C. 78k–1.

[106] *See supra* note and accompanying text. The Commission expects the options exchanges will seek approval from the Commission to amend their existing rules to conform to the Quote Rule.

[107] *See* Brunelle Letter. This commenter believes that because options trades are broken so frequently, public investors, who are required to honor all of their commitments, are held to a much higher standard than exchange market makers. This commenter recommends that in addition to the rules proposed, the Commission require market makers to disclose their failures to honor quotes and completed transactions.

[108] Currently, OPRA does not have the systems capability to collect and disseminate quotes with size. OPRA is, however, scheduled to have this capability by January 2001. Some options markets may, however, choose to continue not to disseminate quote size.

[109] The Commission is including the definition of the term ''option series'' in the Quote Rule. Under Exchange Act Rule 11Ac1–1(a)(29), the term ''option series'' means contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions. 17 CFR 240.11Ac1–1(a)(29).

[110] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 11Ac1–1(d)(2).

[111] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 11Ac1–1(d)(2).

[112] In this regard, several commenters suggested that the Commission wait until OPRA is able to disseminate size before proceeding with the amendments. *See* Susquehanna Letter; Botta Letter; PCX Letter; Phlx Letter; and JPMorgan Letter. One commenter suggested that the Commission adopt this approach to quote size only temporarily. *See* Morgan Stanley Letter. Another commenter characterized the Commission's approach as an ''appropriate solution,'' arguing that the Commission should refrain from mandating that size be disseminated with each quotation until the existing limitations on OPRA systems capacity have been remedied. *See* SIA Letter.

[113] *See* ISE Letter.

[114] *See* Phlx Letter.

proposed amendments to the Quote Rule appeared to be unnecessary. Finally, one commenter recommended that any amendment to the Quote Rule require on-floor specialists and market makers, as well as the options exchanges, to publish on a quote-by-quote basis the size associated with each quote. [115]

The Commission has decided, at this time, not to require the options exchanges to disseminate quotes with size. Currently, OPRA does not have the capability to accept size with options quotes, although it does anticipate disseminating quotes with size in January 2001. The Commission notes that the options exchanges generate significantly more quotes than the equity exchanges. Adding size to quote messages will increase the bandwidth necessary to disseminate options market data, and possibly, increase the number of messages if a new quote is required every time its associated size is modified. As discussed above, over the past year, OPRA has suffered serious capacity constraints due to the tremendous amount of quote message traffic generated by the exchanges. Due to the limitations on OPRA systems capacity, the Commission, while supporting OPRA's efforts to modify its systems to accommodate size, does not believe that it is appropriate to mandate further burdens on OPRA systems capacity at this time.

Pursuant to the amendments to the Quote Rule adopted by the Commission today, the options exchanges will be required to publicize the size for which its quotes will be firm either on a quote-by-quote basis or by publicizing its rule establishing its firm quote sizes. The Commission believes that periodic publication will be sufficient to inform options market participants of the relevant size information they need to make informed order routing decisions. Although the Commission recognizes one commenter's concerns that disseminating quotes with size may require more OPRA systems capacity, the Commission believes that this is a competitive issue and consequently, so long as investors have access to the size information that they require, it is not necessary for the Commission to require the dissemination of quotes with size at this time.

2. Firm Quote Sizes for Customer and Broker-Dealer Orders

The Commission proposed two alternatives regarding the size for which responsible broker-dealers' quotes for listed options would be required to be firm. Under proposed Alternative A, the size for which a responsible broker-dealer's best bid or offer is firm would be required to be the same for orders received from customers and for orders received from broker-dealers. Proposed Alternative B would permit an exchange to establish different firm quote sizes for broker-dealer orders than for customer orders. The Commission requested commenters' views on these two alternatives.

Several commenters supported Alternative A under which the Commission proposed that the firm quote size be the same for both customer and broker-dealer proprietary orders. [116] One of these commenters argued that providing the same firm quote size to all market participants emboldens investor confidence in fair pricing because if the price of a security is too low, then another professional will be ready and able to bring the price in line by entering buy orders, and vice versa for sell orders. This commenter opposed a different firm quote sizes because it believed that this would permit a two-tiered market — one consisting of displayed quotes for non-professionals only, and another, ''shadow'' market for professionals. Further, the commenter argued that the supposition that market makers would widen their spreads if their quotes were exposed to other market professionals is unjustified and unsupported by empirical data, and in any case, the public is more harmed by non-competitive, un-real quotes than by wider spreads. [117] Another of these commenters, however, believed that applying the Quote Rule equally to all market participants would prove unworkable at this time because of the structure of the options market. [118]

On the other hand, several commenters preferred allowing responsible broker-dealers to be firm for different sizes for customers and broker-dealers, as proposed in Alternative B.[119] Some commenters argued that if market makers were required to establish a single quotation size for all market participants, they would likely decrease the disseminated size of their quotes and their execution guarantees, limiting liquidity available to customers.[120] They argued that the ability to establish differing quote sizes for broker-dealer and customer orders would allow market makers to provide customers with greater liquidity, while limiting their exposure to non-customers.[121] Other commenters argued that market makers, not the Commission, should determine how much liquidity they want to guarantee to professionals.[122]

One commenter explained that market makers provide different liquidity guarantees to professional orders to protect against being ''picked off,'' and noted that if market makers quote less aggressively, public customers whose orders are generally automatically executed at the NBBO could be adversely affected.[123] This commenter noted that market makers compete against each other by guaranteeing different sizes, which would be eliminated if only one quote size applied to all types of orders. Another commenter argued that options market makers are at far greater risk than stock specialists of being picked off by professionals and that it would be exponentially more difficult for an options market maker than for a stock specialist to provide continuously updated quotes that would be firm against professional interest.[124] However, another commenter noted that the equity market does not exempt traders and market makers from the Quote Rule when dealing with other broker-dealers.[125]

After careful review of the commenters' observations and suggestions, the Commission is adopting amendments to the Quote Rule that allow the options exchanges to establish different firm quote sizes for broker-dealer orders than for customer orders.[126] An exchange that chooses not to collect from their members and make available to vendors the size associated with each quotation in listed options may establish by rule and periodically publish the size at which its best bid or offer in each options series listed on the exchange is firm for orders from customers and orders from broker-dealers.[127] An exchange would also have the flexibility to collect from its members and make available to quotation vendors the quotation sizes at which such members are firm for customer orders and, at the same time, to establish by rule and periodically

[115] *See* Brunelle Letter.

[116] *See* JPMorgan Letter; ISE Letter; Lek Letter; Wolverine Letter; and Morgan Stanley Letter.

[117] *See* Lek Letter.

[118] *See* ISE Letter.

[119] *See* Botta Letter; CBOE Letter; PCX Letter; Susquehanna Letter; and SIA Letter.

[120] *See* Botta Letter; CBOE Letter; PCX Letter; ISE Letter; Susquehanna Letter; and SIA Letter.

[121] *See* PCX Letter; CBOE Letter; and ISE Letter.

[122] *See* Susquehanna Letter and Botta Letter.

[123] *See* Botta Letter.

[124] *See* Susquehanna Letter.

[125] *See* Lek Letter.

[126] Exchange Act Rule 11Ac1–1(d)(1), 17 CFR 240.11Ac1–1(d)(1). Exchange rules must require responsible broker-dealers to be firm for orders for the accounts of broker-dealers for at least one contract.

[127] Exchange Act Rule 11Ac1–1(d)(1)(ii), 17 CFR 240.11Ac1–1(d)(1)(ii).

publish a different size for which their members' quotes must be firm for broker-dealer orders.[128]

The Commission believes that the unique structure of the options markets, specifically, the tremendous number of products that must be continuously quoted by options market makers or specialists, warrants this specific accommodation. Currently, there are approximately 178,000 options series for which options market makers and specialists continuously provide two-sided quotations. Consequently, the Commission believes that permitting different quote size guarantees is the best course of action at this time to help ensure the continued availability of liquidity, which facilitates the maintenance of fair and orderly markets. The Commission will, however, continue to evaluate the markets to determine if, in fact, this provision is warranted.

3. Minimum Quote Size

In the Proposing Release, the Commission requested commenters' views on whether the Commission should establish a minimum number of contracts for which quotes should be firm. The Commission received no comments in support of mandating a minimum firm quote size.[129]

Two commenters did suggest that in absence of a mandated minimum firm quote size, quotes should be firm for at least one contract, which has the economic equivalent of 100 shares of stock, the minimum quote size in the equities markets.[130] One of these commenters believed that the minimum firm quote size should be viewed as a competitive, rather than a regulatory, issue.[131] Other commenters argued against a minimum firm quote size because any such minimum would facilitate and encourage wide-scale proprietary trading by broker-dealers on markets in which they are not members.[132] One of these commenters believed that non-members of an exchange should not be allowed to gain free access to the exchange, because such access could dilute the value of exchange memberships.[133]

The Commission agrees that quote size is a competitive issue and should not be dictated by regulation. Under the Quote Rule adopted today, each options exchange will be required to publicize the size at which their market makers or specialists are firm. The Commission believes that competitive market forces will dictate appropriate firm quote sizes for customer and broker-dealer orders in the options markets.

Nevertheless, the Commission believes that each disseminated quote must represent at least one contract — any less would mean that a quote was not actually firm. For this reason, the Commission is adopting a requirement that if an exchange allows quotes to be firm in different sizes for broker-dealer orders than for customer orders, its rules must require its market makers to be firm for a minimum of one contract. As noted by one of the commenters, one contract is the economic equivalent of 100 shares of stock and therefore, this requirement establishes in the options market a standard equivalent to that applied in the equities market.

On a related note, the Commission believes that in those instances in which a quote is disseminated by an exchange that collects and aggregates quotation sizes from several responsible broker-dealers, each responsible broker-dealer would be required to be firm for at least one contract for broker-dealer orders.[134] Therefore, for example, if an exchange collects and disseminates a quote, the size of which reflects the aggregate size of three competing responsible broker-dealers, the exchange quote must be firm to orders from broker-dealers for at least three contracts, one for each responsible broker-dealer.[135]

4. Automatic Execution Systems

The amendments to the Quote Rule adopted today do not affect the ability of the options exchanges to provide execution guarantees through their automatic execution systems. The exchanges' automatic execution systems are generally used for small, public customer market and marketable limit orders. Options exchanges will continue to have the flexibility to publish a different firm quote size for a particular options class than its automatic execution guarantee size. The Commission, however, may reevaluate this approach if it results in a decrease in liquidity available for customer orders.

5. Exception During Trading Rotations

Under the Quote Rule, responsible brokers or dealers are relieved of their obligations if, for example, the responsible broker or dealer is in the process of effecting a transaction and immediately thereafter, communicates a revised quotation. The amendments to the Quote Rule being adopted today also relieve responsible brokers or dealers from their firm quote obligations when an order for listed options is presented during a trading rotation in that listed option.[136] During trading rotations, market makers may be unable to generate quotes in a timely fashion. The Commission is adopting as part of the Quote Rule the definition of ''trading rotation'' proposed in the Trade-Through Disclosure Rule, with a slight modification.[137] Specifically, the definition of trading rotation has been modified to include references to reopening and closing rotations, as well as to opening rotations as proposed, because the same difficulties in providing firm quotes during opening rotations apply during those other types of trading rotations.[138]

6. Thirty-Second Response

As discussed above, if a responsible broker or dealer fails to respond to an incoming order within the 30 seconds, the Trade-Through Disclosure Rule permits the routing broker or dealer to execute its customer's order at an inferior quote without being required to disclose the better, but unresponsive, quote to its customer.[139] The Commission is adopting an amendment to the Quote Rule[140] to require a responsible broker or dealer to respond to an order to buy or sell a listed option in an amount greater than the firm quote size within 30 seconds by either: (i) executing the entire order; or (ii) executing at least that portion of the order equal to the applicable firm quote size and revising its bid or offer.[141] The

[128] Exchange Act Rule 11Ac1–1(d)(1)(iii), 17 CFR 240.11Ac1–1(d)(1)(iii).

[129] *See* PCX Letter; Phlx Letter; JPMorgan Letter; ISE Letter; CBOE Letter; and Susquehanna Letter.

[130] *See* PCX Letter and SIA Letter.

[131] *See* PCX Letter.

[132] *See* Phlx Letter and Morgan Stanley Letter.

[133] *See* Phlx Letter.

[134] For customer orders, each responsible broker-dealer will be firm for its published size.

[135] In comparison, exchanges that disseminate one quote for a trading crowd, based on a single, automatically generated quote would be required to be firm only for a minimum of one contract.

[136] Exchange Act Rule 11Ac1–1(d)(4)(ii), 17 CFR 240.11Ac1–1(d)(4)(ii).

[137] The Commission did not propose in the Proposing Release to include a definition of the term ''trading rotation'' in the Quote Rule.

[138] Exchange Act Rule 11Ac1–1(a)(30), 17 CFR 240.11Ac1–1(a)(30).

[139] Exchange Act Rule 11Ac1–7(b)(4)(iv), 17 CFR 240.11Ac1–7(b)(4)(iv).

[140] Exchange Act Rule 11Ac1–1(d)(3), 17 CFR 240.11Ac1–1(d)(3). A responsible broker's or dealer's applicable firm quote size would be its published quote size or, if a responsible broker or dealer has been relieved of the obligation to communicate its quotation sizes, the minimum firm quote size established by its exchange's rules. One commenter noted that the proposed amendments to the Quote Rule failed to incorporate the use of a defined term, ''published quotation size,'' where applicable. *See* ISE Letter. In response to the comment, the Commission is adopting technical amendments to the Quote Rule to more uniformly apply the defined term, published quotation size.

[141] When a responsible broker-dealer chooses to respond to an order in an amount greater than the firm quote size by executing only that portion of the

Quote Rule requires responsible brokers and dealers to *immediately* execute an order to buy or sell listed options in an amount equal to or less than its firm quote size.[142]

The Commission requested comment on its proposal to require responsible broker-dealers, within 30-seconds, to either execute an entire order or execute that portion of an order that is equal to its firm quote size, and thereafter revise its bid or offer. One commenter stated that, ultimately, the Commission should require that quotes be subject to automatic or nearly automatic executions.[143] Similarly, several other commenters considered 30 seconds too long because it imposed unnecessary market risk on customers and could result in market makers abusing the time period by holding orders until the last second in an attempt to gain an advantage.[144] One commenter suggested that market makers be required to immediately respond to orders that are not larger than the disseminated quote size and respond within 15 seconds, which is the turnaround time in the Linkage Plan, to orders of greater size.[145] Another commenter suggested a 10-second response time would be more appropriate.[146]

Further, because different types of orders require different handling procedures, which means that execution times will be different, one commenter opposed any requirement that would institute an across-the-board 30-second reporting requirement for all orders.[147] This commenter suggested that the Commission defer any decision on this issue until the Linkage Plan has been implemented and the exchanges have gained some experience and data regarding turnaround times. In addition, this commenter suggested that if the Commission extends trade-through protection to markets that do not participate in any approved linkage plan, 30 seconds may be too long a time period for those instances in which an order is routed to a market that does not participate in any approved linkage plan, because there may not be a guarantee of an execution in the event that such market backs away from its quote or is not firm for the entire order.

Finally, another commenter believed that the 30-second response time would not delay trades but suggested that the Commission make an exception for fast market conditions, and remain open to changing the response time as technology improves.[148]

For orders greater than an exchange's firm quote size, the Commission is adopting the 30-second response requirement, as proposed. The Commission believes that the Quote Rule currently requires responsible broker-dealers to immediately execute orders in a size up to its firm quote size and is not amending that requirement as applied to options. Accordingly, orders equal to or smaller than a responsible broker-dealers' firm quote size must be immediately executed.

The Commission believes that it is appropriate to establish a time limit by which a recipient market maker must execute an order larger than its quote, or change its quote. The Commission believes that a time period must be set forth in the rule to prevent broker-dealers from waiting an inordinate amount of time before executing an order or changing their quote. In this regard, the Commission is concerned that in the absence of a set time frame, the execution of orders may be unduly delayed. Therefore, at this time, the Commission believes that the 30-second time limit appropriately balances the need for price priority against the need for efficient execution of orders. The Commission will, however, evaluate this time frame as the exchanges implement these amendments and as technology progresses to determine if another time frame is more appropriate.

7. One-Percent Exception

Under the Quote Rule exchanges are required to collect and make available the quotes communicated to them by responsible broker-dealers for subject securities. A subject security is any exchange-traded security except a security for which an exchange's executed volume during the most recent calendar quarter comprised one percent or less of the aggregate trading volume for such security as reported to OPRA, and any security actually quoted by an exchange.[149] One commenter believed that this exception was not necessary for listed options.[150] This commenter argued that the possibility of a chilling effect on the liquidity of inactively-traded securities would not justify the monitoring burden that the exception would impose on brokers, who would be forced to keep track of which quotes were firm and which, due to the one percent exception, were not.

The Commission believes that the options markets and options market makers should be permitted to make use of the one percent exception. The Commission is not persuaded that this exception, applied for years in the equity markets, will impose significant compliance burdens on market participants. Any quote actually published by the exchange must be firm.

8. Amendments to Defined Terms

To effectuate the application of the Quote Rule to listed options, the Commission is amending several defined terms used in that rule. In particular, the Commission is expanding application of the Quote Rule to include transactions in listed options [151] by amending the definition of the term "reported security," [152] to include any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan [153] or an effective national market system plan for reporting transactions in listed options.[154] Consequently, listed options are now also included within the definitions of "covered security," [155]

order equal to the firm quote size, and thereafter, revising its bid or offer to an inferior price, the Commission expects that, in the absence of a price movement in the underlying security, the responsible broker-dealer will not reinstate its original bid or offer for at least thirty seconds. A responsible broker-dealer may not reinstate its bid or offer for at least thirty seconds even if a competing market maker independently quotes at the original price during the thirty second period.

[142] Exchange Act Rule 11Ac1–1(c)(2), 17 CFR 240.11Ac1–1(c)(2).

[143] *See* Morgan Stanley Letter.

[144] *See* Phlx Letter; ISE Letter; and Brunelle Letter.

[145] *See* ISE Letter.

[146] *See* Brunelle Letter.

[147] *See* CBOE Letter.

[148] *See* JPMorgan Letter.

[149] *See* Exchange Act Rule 11Ac1–1(a)(25), 17 CFR 240.11Ac1–1(a)(25).

[150] *See* JPMorgan Letter.

[151] The Commission defines the term "listed option" in the Quote Rule as any option traded on a registered national securities exchange or automated facility of a registered national securities association. *See* Exchange Act Rule 11Ac1–1(a)(27), 17 CFR 240.11Ac1–1(a)(27).

[152] One commenter noted that by changing the definition of reported security in the Quote Rule, options would be subject to the Limit Order Display Rule, Exchange Act Rule 11Ac1–4, 17 CFR 240.11Ac1–4, which incorporates by reference the definition of reported security in the Quote Rule. *See* JPMorgan Letter. As the Commission did not intend to amend the Limit Order Display Rule in this manner, the Commission is adopting a conforming amendment to the definition of reported security in the Limit Order Display Rule, to retain the existing definition in that rule.

[153] All national securities exchanges and national securities associations must file with the Commission a transaction reporting plan regarding transactions in listed equity and Nasdaq securities. *See* Exchange Act Rule 11Aa3–1(b)(1), 17 CFR 240.11Aa3–1(b)(1).

[154] Currently, the OPRA Plan is the only effective national market system plan that collects, processes, and makes available transaction reports for listed options.

[155] The term "covered security" is defined as any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Exchange Act, 15 U.S.C. 78c(a)(51)(A)(ii). *See* Exchange Act Rule 11Ac1–1(a)(6), 17 CFR 240.11Ac1–1(a)(6).

''exchange-traded security,'' [156] and ''subject security.'' [157] Thus, options exchanges and market makers are obligated to publish their quotes and, as importantly, be firm for those quotes.

In addition, the Commission is amending the definition of ''consolidated system'' under Rule 11Ac1–1(a)(5) [158] to include a transaction reporting system operating pursuant to an effective national market system plan, as proposed. The effect of this amendment is to make clear that listed options would be ''subject securities'' with respect to an exchange or association only if, during the most recent calendar quarter, the exchange or association chooses to publish quotes or the aggregate trading volume on such exchange or association is more than one percent of the aggregate trading volume as reported by OPRA.

9. Compliance Date

The amendments to the Quote Rule become effective on February 1, 2001, and have a compliance date of April 1, 2001. Although several commenters recommended that market makers and exchanges not be required to comply with the amendments to the Quote Rule until OPRA is able to disseminate quotes with size,[159] the Commission believes that these amendments will provide significant benefits to options market participants and does not believe that they should be delayed while OPRA develops new systems changes. Further, because the options exchanges will not be required to disseminate size on a quote-by-quote basis, market makers and exchanges can comply with the amendments to the Quote Rule even if OPRA is unable to accept quotes with size by April 1, 2001.

V. Paperwork Reduction Act

Certain provisions of the new rules contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[160] Accordingly, the Commission submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Commission proposed, and OMB approved, amendments to the collection of information titled ''Rule 11Ac1–1, Dissemination of Quotations'' (OMB Control Number 3235–0461). The Commission also proposed to create a new information collection entitled ''Rule 11Ac1–7, Trade-Through Disclosure Rule.'' OMB has approved the new collection, and has assigned it OMB Control Number 3235–0543, with an expiration date of November 30, 2003. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless it displays a currently valid OMB control number.

The Proposing Release solicited comments on these collection of information requirements.[161] No comments were received that addressed the PRA portion of the Proposing Release. The Commission believes that its previously published estimates of the information collection burdens associated with the new rule and rule amendments are appropriate.

Any collection of information pursuant to the new rules would be mandatory. Market centers that are national securities exchanges or national securities associations would be required to retain the required collections of information for not less than five years, the first two years in an easily accessible place. Broker-dealers would be required to retain the collections of information for not less than three years, the first two years in an easily accessible place.

A. Use and Disclosure of the Information Collected

The information collected pursuant to the Trade-Through Disclosure Rule would be sent to customers and retained by broker-dealers. No information, however, will be collected or retained under this rule if all of the options exchanges participate in an effective national market system options linkage plan that is reasonably designed to limit intermarket trade-throughs. This information would be used by customers to evaluate the quality of the executions they receive. It would also be used by broker-dealers to evaluate and make determinations related to their best execution obligations. The Commission and the options markets would use the information collected pursuant to the rule for inspections, examinations, trading reconstructions, enforcement inquiries or investigations.

The information collected pursuant to the Quote Rule would be held by broker-dealers and markets. Customers of broker-dealers, as well as other market participants, would use this information to determine the sizes associated with the best prices available for listed options. The Commission and self-regulatory organizations (''SROs'') would use the information collected pursuant to the rule for inspections, examinations, trading reconstructions, enforcement inquiries or investigations.

The Commission and other securities regulatory authorities would obtain possession of the information only upon request. Any collection of information received by the Commission, SROs, and other securities regulatory authorities would not be disclosed under the terms of the proposal, subject to the provisions of the Freedom of Information Act, 5 U.S.C. 552.

B. Trade-Through Disclosure Rule

1. Capital Costs

As the Commission noted in the Proposing Release, if a broker-dealer effects trades on a market that participates in an approved linkage plan with provisions reasonably designed to limit intermarket trade-throughs, including trade-throughs of prices on markets not participating in a linkage plan, the broker-dealer will have no paperwork capital costs or paperwork burdens under the Trade-Through Disclosure Rule. The same will hold true if all options markets participate in such a linkage plan. As noted above, all five options exchanges are currently participants in the Linkage Plan approved by the Commission on July 28, 2000.[162] Only minor modifications to the Linkage Plan are necessary for it to be considered reasonably designed to limit intermarket trade-throughs.

The Trade-Through Disclosure Rule would require broker-dealers to make certain disclosures to customers if the broker-dealer effects trades on markets that do not participate in an approved linkage plan. Broker-dealers would incur paperwork costs to modify systems to permit them to: (1) Receive information about when a trade-through has occurred and the price that was traded through; (2) match information about trade-throughs with customer accounts; and (3) disclose to customers when trade-throughs occur. The Commission has estimated that it would take a computer programmer at an

[156] The term ''exchange-traded security'' is defined as any covered security or class of covered securities listed and registered, or admitted to unlisted trading privileges, on an exchange. *See* Exchange Act Rule 11Ac1–1(a)(10), 17 CFR 240.11Ac1–1(a)(10).

[157] The term ''subject security'' is defined to include any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system. *See* Exchange Act Rule 11Ac1–1(a)(25), 17 CFR 240.11Ac1–1(a)(25).

[158] Exchange Act Rule 11Ac1–1(a)(5), 17 CFR 240.11Ac1–1(a)(5).

[159] *See* Susquehanna Letter; Botta Letter; PCX Letter; Phlx Letter; and JPMorgan Letter.

[160] 44 U.S.C. 3501 *et seq.*

[161] *See* Proposing Release, *supra* note .

[162] *See* Linkage Plan, *supra* note 4.

hourly rate of approximately $50 [163] between 500 and 1,000 hours to modify the average broker-dealer's systems to receive trade-through information, at a cost of between $25,000 and $50,000 for each broker-dealer. Approximately 7,500 broker-dealers were registered with the Commission as of December 31, 1999. Of those, approximately 3,800 conduct business with the general public. Most introducing firms, however, rely on their clearing firms to generate confirmation statements for customers.[164] As a result, fewer than 330 broker-dealers would actually have to modify their systems, should any modifications be necessary. However, if all 330 registered broker-dealers that clear customer accounts pursuant to Exchange Act Rule 15c3–3 [165] were required to make these systems modifications, the one-time paperwork cost would be between $8,250,000 and $16,500,000.

2. Burden Hours

If a broker-dealer effects trades on markets that do not participate in an approved linkage plan with provisions reasonably designed to limit intermarket trade-throughs, including trade-throughs of prices on markets not participating in an approved linkage plan, the broker-dealer would be required to disclose trade-throughs to its customers. However, because broker-dealers' systems would have already been reprogrammed to receive information about trade-throughs and to appropriately disclose such trade-throughs to customers, the Commission has estimated that the paperwork burden of the disclosure for broker-dealers would be nominal, since it would merely require a small amount of additional information to be provided to customers at or before the completion of the transaction on confirmation statements, or in some equivalent fashion.[166]

C. Amendments to the Quote Rule

1. Capital Costs

In the Proposing Release, the Commission noted that options exchanges are obligated already, pursuant to their participation in the OPRA Plan, to collect bids and offers, and send them to OPRA for dissemination. However, under the amended Quote Rule, the options exchanges will be required to either collect and make available to vendors quotation sizes associated with such bids and offers, or to establish by rule and periodically publish the sizes for which a quote must be firm, and to file proposed rule changes to identify unusual market conditions.

If an exchange chooses not to collect and make available to vendors quotation sizes associated with its members' bids and offers, but instead chooses to implement rules and periodically publish such rules establishing the sizes for which its quotes will be firm, it would incur one-time costs to file and obtain approval of these rule changes, as well as other related rules. The Commission estimated that each of the five options exchanges would need to file two rule changes to comply with the proposed amendments to the Quote Rule, for a total of 10 rule changes. The Commission has estimated that a routine rule change requires approximately 25 hours of legal review at an hourly cost of $98.25,[167] plus one hour of secretarial time at an hourly cost of $30.40,[168] for a total cost of $2,487 per proposed rule change submitted for Commission approval. Therefore, the Commission has estimated that the aggregate cost of two proposed rule changes filed by each of the five options exchanges would total approximately $24,867.

Also, as noted in the Proposing Release, broker-dealers that are market makers or specialists have existing obligations under exchange rules to communicate their bids and offers to their exchanges, and already do so. Therefore, they would incur no additional paperwork costs from the amended Quote Rule beyond those related to systems changes, discussed below, to comply with the amended Quote Rule. Market makers and specialists may, to comply with the amended Quote Rule, change their quote-setting practices by changing the factors used to establish quotes through automated quoting systems (*i.e.*, resetting the parameters). The Commission notes that almost all option quotes are currently set by automated quoting systems. The Commission estimated broker-dealer systems changes made to comply with the amended Quote Rule would require changes estimated to take approximately three to five minutes per options class. As there are approximately 3,000 options classes eligible for multiple listing, the Commission estimated that the total burden for one market could range from 180 to 250 hours. For all five markets, the total burden could range from 900 to 1,255 hours. The hourly rate of an exchange clerk that would make the required system changes is $32.50;[169] therefore, the total cost for these changes could range from $29,250 to $40,787.

2. Burden Hours

The Commission estimated that the five options exchanges may, to comply with the Quote Rule, amend their rules at most once per year, for a total of five proposed rule changes. The Commission estimated that a routine proposed rule change takes 25 hours of legal review at an hourly cost of $98.25 [170] plus one hour of secretarial time at an hourly cost of $30.40,[171] for a total cost of $2,487 per proposed rule change. Therefore, the total annual cost of five exchanges' proposed rule changes would impose a burden of $12,433.

Broker-dealers would not incur any additional paperwork cost from the amended Quote Rule beyond the systems changes discussed above. Market makers and specialists already are required to make and provide quotes in options to their exchanges. As a result, the amendments to the Quote Rule to include options would require only that market makers and specialists be firm for their quotes, which would impose no additional paperwork burden on them.

VI. Costs and Benefits of Final Rules

Recent increases in the multiple listing of options classes previously listed on a single exchange have

[163] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Management and Professional Earnings in the Securities Industry 1999, published by the SIA (''SIA Report'').

[164] The Commission estimates that none of the 41 small broker-dealers who do not have a relationship with a clearing firm regularly represent customer options orders.

[165] 17 CFR 240.15c3–3.

[166] The Commission's adoption of an exception to the disclosure requirement of the Trade-Through Disclosure Rule for block orders would only reduce this burden. Because this burden was already determined to be nominal, this change does not affect the Commission's initial burden estimate. *See* Proposing Release, *supra* note 6.

[167] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[168] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Office Salaries in the Securities Industry 1999.

[169] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[170] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* SIA Report *supra* note 163.

[171] The hourly rate contains 35% overhead, which includes, among other costs, telephone, postage and copying. *See* Report on Office Salaries in the Securities Industry 1999.

intensified the competition among the option exchanges and heightened the need to further integrate the options markets into the national market system. While the growth in multiple trading has increased the competition between markets, it also has dramatically altered the environment in which options market participants conduct their trading. In particular, multiple trading raises new best execution challenges for brokers. When an option is listed on only one exchange, brokers do not have to decide where to route an order, and consequently, satisfying their best execution obligations is less complex than when they must consider the relative merits of routing orders to two or more market centers. With as many as five options exchanges currently trading certain options classes, brokers are required to regularly and rigorously evaluate on a more frequent basis the execution quality available at each options exchange.

Directly relevant to a broker's ability to obtain best execution for its customers is the ability to get the best price available. The considerable growth in the number of options classes traded on more than one exchange has significantly increased the likelihood of intermarket trade-throughs. With the current expansion of multiple trading in options, the Commission is increasingly concerned about customer orders, which are sent to one exchange, and executed at prices that are inferior to quotes published by another market. As a result, the Commission believes that adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on another market.

A. Costs and Benefits of the Trade-Through Disclosure Rule

Under the Trade-Through Disclosure Rule, a broker generally will be required to disclose to its customer, in writing at or before the completion of the transaction, when the customer's order for listed options was executed at a price inferior to a better published quote and the better published quote available at that time.[172] A broker-dealer will not be required to make this disclosure if any of the four exceptions to the definition of a trade-through apply, which include when: (1) The market on which the order is executed has verified that the market publishing the better price is experiencing systems problems, which make the quote inaccessible, (2) OPRA is experiencing queuing, (3) the market publishing the better price is relieved of its obligations to publish firm quotes, or (4) the market publishing the better quote fails to respond to an order routed to it within 30 seconds.

A broker-dealer also will not be required to provide such disclosure to its customer if it effects the transaction on an exchange that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price or the customer order was executed as part of a block trade.[173] Exchanges also will be required to surveil and sanction specialists or market makers that trade through better prices published by other exchanges, particularly because under the intermarket linkage plan exception, broker-dealers need not disclose to their customers if their orders are executed at a price inferior to a quote published by another market.

1. Comments

In the Proposing Release, the Commission requested comments on all aspects of the costs and benefits of the rule, including identification of additional costs or benefits of the new rule. In addition, the Commission encouraged commenters to identify or supply any relevant data concerning the costs or benefits of the new rule.

None of the commenters specifically addressed the costs or benefits of the proposed Trade-Through Disclosure Rule. However, several commenters discussed certain aspects of the Commission's proposal, which implicitly addressed the costs or benefits of the proposal, such as the likelihood that the rule would help to prevent trade-throughs and therefore, implicitly the associated costs of trade-throughs to investors. For example, one commenter believed that trade-throughs would be virtually eliminated if a broker-dealer were required to disclose to a customer that an order was executed at a price that was inferior to the best-published quote.[174] In addition, another commenter believed that a linkage plan must provide some form of protection against trading through exchanges that do not participate in an approved linkage plan to instill investor confidence in the options markets.[175]

One commenter, however, did not believe that the imposition of a disclosure requirement would have a significant impact on the frequency of trade-throughs.[176] In addition, another commenter believed that the Commission should modify the provisions it requires for a linkage plan to satisfy the exception to the disclosure rule so that the recently approved Linkage Plan[177] qualified as reasonable without further amendment.[178] The commenter believed that the additional factors proposed as elements of a plan reasonably designed to limit trade-throughs would add significant costs to the Linkage Plan without adding significant additional deterrence.[179] In addition, this commenter believed that if all or almost all of the options exchanges are expected to join the Linkage Plan, the Commission should delay the adoption of the rule, because it would not be cost-effective to require firms to re-design their confirmation systems to comply with such a rule if the rule then became obsolete because all of the exchanges were members of an approved linkage that meets the rule's requirements. Another commenter believed that the Commission should not extend trade-through protection to those markets that are not members of the same linkage plan because they would be difficult to access effectively.[180]

2. Benefits

An intermarket trade-through may be costly to an investor primarily because the investor receives an execution at a price that is not the best price available. An intermarket trade-through also has potential costs for the broker-dealer or customer responsible for the best quote because that quote or customer order does not receive the execution it would have if the order that was executed at the inferior price were instead routed to it.[181] Consequently, intermarket trade-throughs may increase the incidence of unexecuted customer limit orders not being executed in a timely manner.

[172] Exchange Act Rule 11Ac1–7(b)(1), 17 CFR 240.11Ac1–7(b)(1). The Commission believes that a broker-dealer should be allowed to rely on the market of execution to notify the broker-dealer of when a trade-through has occurred and the best quote at that time.

[173] Exchange Act Rule 11Ac1–7(b)(2), 17 CFR 240.11Ac1–7(b)(2).

[174] *See* Lek Letter.

[175] *See* ISE Letter.

[176] *See* CBOE Letter.

[177] *See supra* notes 4 and 5 and accompanying text.

[178] *See* JPMorgan Letter.

[179] *See* JPMorgan Letter.

[180] *See* CBOE Letter.

[181] It is possible that an order may not be routed to the market publishing the best quote, if the original market matches the better quote. However, the Commission believes that the Trade-Through Disclosure Rule may ensure that the customer submitting the order will at least receive an execution at the better published price.

To attempt to gauge the incidence of intermarket trade-throughs, the staff looked at trading involving the 50 most active, multiple-listed options classes, in which there is a great deal of investor interest. The staff's review of these trades showed that approximately 5% of all trades (or 7,964 trades for a total of 156,403 contracts) in the 50 most active multiple-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[182] To better evaluate the execution quality of small customer orders, the staff also examined automatic execution trades in the 50 most active multiple-listed options classes. The staff also found that approximately 1% of all automatic execution trades (or 464 automatic execution trades for a total of 2,336 contracts) in the 50 most active multiple-listed option classes took place at prices inferior to the best price quoted on a competing exchange during the week of June 26, 2000.[183]

Investors would benefit from the Trade-Through Disclosure Rule because they would be informed when their orders are executed at a price inferior to the best available price. With that information, investors would have the opportunity to reduce the likelihood that their orders would be executed at a price inferior to a price displayed by another market by selecting broker-dealers that effect their transactions on markets that are participants in an approved linkage plan with provisions reasonably designed to limit trade-throughs. Even if only one-half of all orders executed through automatic execution systems were executed at the best-published quote (*i.e.,* trade-throughs of automatic execution trades were eliminated), the estimated annual savings to investors trading through exchanges' automatic execution systems would be approximately $5,500,000 each year.[184] If all trades were considered, the elimination of trade-throughs would result in substantially higher annual savings to investors.[185]

3. Costs

The Trade-Through Disclosure Rule may require broker-dealers and markets to incur capital costs, such as one-time costs to modify existing systems. For example, the new rule could impose one-time costs on markets and broker-dealers that must modify systems to determine when trade-throughs have occurred and to issue notifications to customers of trade-throughs. Further, to identify when an order trades through a posted quote, information systems would need to be developed that could identify the displayed quotes at the time of execution. Because the Commission would allow broker-dealers to rely on notifications from the markets when trade-throughs occur and the better available quote at that time, the costs of such information systems may be borne by the options markets.

In addition, implementing the rule could require broker-dealers to provide customer notifications at or before the completion of the transaction. A broker-dealer may provide this disclosure to its customers in conjunction with the confirmation statements routinely sent to customers and could be issued in either electronic or paper form.[186] An alternative to changing confirmation statements would be for broker-dealers to route orders to exchanges participating in an approved linkage plan.[187] Although the new rule does not require the implementation of such a plan, it does envision that an approved plan could be implemented. Thus, one possible cost to the options markets of the Trade-Through Disclosure Rule could be the capital investment to establish a linkage. In addition to the capital costs of establishing the linkage, costs could include regulatory costs, such as obtaining Commission approval of a linkage and of SRO rule changes necessary to implement a linkage. Further, there may be economic implications if a market chooses to participate in an approved linkage plan, because members may then be more likely to use the linkage to route orders to other exchanges that are quoting a better price. The Commission estimates that capital costs for a linkage plan range from $1,000,000 to $1,500,000 initially, and yearly costs could range from $300,000 to $1,000,000.[188]

The Commission recognizes that broker-dealers may incur certain capital costs to implement the Trade-Through Disclosure Rule. While the Commission recognizes that these costs cannot be avoided, the Commission believes that most of these costs will be one-time costs for broker-dealers with continuing savings to investors through the elimination of trade-throughs. Also, as members of the options exchanges, broker-dealers may have input into a decision by an exchange to participate in an options linkage plan and therefore, influence decisions that will impact their costs, including potential exchange fees.

The Commission is also sympathetic to the comment that the rule may become obsolete if all the options exchanges participate in an approved intermarket linkage plan.[189] The Commission is not mandating participation in a particular intermarket linkage plan to allow the options exchanges to retain greater flexibility. Because participation in an options linkage plan is voluntary and because, under the current terms of the Linkage Plan, any participant may withdraw from the plan at any time with 30 days prior written notice to each of the other plan participants and the facilities manager, if any,[190] the Commission continues to believe that the Trade-Through Disclosure Rule is needed to ensure that, if the exchange on which their orders are executed do not belong to an approved linkage plan with provisions designed to limit trade-throughs, investors at least receive

[182] The staff relied on data from OPRA for this analysis. All trades marked as spreads, straddles, late, or stopped were excluded from the sample. To determine the quote in effect at the time of the trade, the highest offer and lowest bid on each competing exchange for a period of one minute prior and two minutes after the reported execution were identified. Quotes from an exchange that indicated it was experiencing fast market conditions during the time when the trade was executed were not included. Quotes that indicated that an option class was in rotation were also excluded. The staff recognizes that not all these trades in the sample could be fully executed at the best available quoted price because of size or other factors.

[183] Trades executed through automatic execution systems account for about 36% of all trades and about 12% of all contracts traded in the 50 most active multiple-traded options classes during the week of June 26, 2000. The procedure used for the analysis of automatic execution trades is similar to that described for all trades, except only trades executed through the exchanges' automatic execution systems are included.

[184] The annual benefit estimate is obtained by applying the staff's trade-through findings for automatic execution trades in the 50 most active multiple-traded options classes to all multiple-listed classes and extending the results from one week to a full year. In the options market, market makers are almost always on the other side of the transaction and therefore, investors benefit from avoiding trade-throughs. If investors were on both sides of the transactions, any savings for avoiding trade-throughs would be offset by losses to investors on the opposite side of the transactions.

[185] The staff estimates the benefits of executing a maximum of 20 contracts at the best-quoted price for those trades identified as trade-throughs could total several hundred million dollars per year.

[186] See Securities Exchange Act Release No. 37182 (May 9, 1996), 61 FR 24644 (May 15, 1996).

[187] The Commission notes that Trade-Through Disclosure Rule creates strong incentives for the options exchanges to participate in an approved intermarket linkage plan to attract order flow from broker-dealers wishing to avoid the disclosure requirement.

[188] The Commission published these numbers in the Proposing Release and specifically solicited comment on the costs of developing a linkage between the markets, as well as the costs for individual markets to integrate their systems into such a plan. The Commission did not receive any comments on the above data.

[189] *See* JPMorgan Letter.

[190] *See* Linkage Plan, Section 12.

disclosure if their orders are not executed at the best price.

The Commission recognizes that by providing an incentive for markets to cooperate in developing effective means to access other markets, trade-throughs will be minimized. However, to the extent that: (1) One or more options exchanges decide not to participate in a linkage plan; (2) trade-throughs are not minimized by the implementation of an intermarket linkage plan because the plan fails to provide protection across all markets, including markets that do not participate in a linkage plan; (3) away markets fail to complain about trade-throughs; or (4) broker-dealers are not subject to potential sanctions for trade-throughs, the value of the Trade-Through Disclosure Rule would be greatly diminished. Therefore, the Commission believes that despite the existing exchanges' participation in the Linkage Plan, the Trade-Through Disclosure Rule adopted by the Commission is also needed for the protection of investors. The Commission believes that the rule can only be effective if trade-throughs of any market are disclosed to investors, or effectively limited by an approved linkage plan.

B. Costs and Benefits of Amendments to the Quote Rule

The Commission is adopting amendments to the Quote Rule to extend its application to options traded on national securities exchanges. Generally, the Quote Rule requires exchanges to collect quotations and sizes from its responsible broker-dealers and make those quotations and sizes available to quotation vendors for each subject security listed and admitted to unlisted trading privileges on the exchange.

The Commission is adopting amendments to the Quote Rule to accommodate the unique structure of the options market to permit options exchanges to decide whether or not to collect from their members and make available to vendors the size associated with each quotation in listed options. Instead, exchanges may choose to establish by rule and periodically publish the size for which its best bid or offer in each options series that is listed on the exchange is firm. If the rules of the exchange do not require its members to communicate quotation sizes for listed options, responsible broker-dealers that are members of that exchange will be relieved of their obligations under the Quote Rule to communicate to that exchange their quotation sizes. Instead, each responsible broker-dealer may satisfy its firm quote obligation by executing any order to buy or sell a listed option that is a subject security, in an amount up to the size established by the exchange's rules.[191] An exchange may establish in its rules different firm quote sizes for broker-dealer orders than for customer orders.[192]

If, on the other hand, an options exchange chooses to establish procedures for collecting from its members, and making available to vendors, the sizes of its members' quotes, the exchange may permit its members' quotes to be firm for different sizes for customer orders than for broker-dealer orders.[193] In addition, an exchange will have the flexibility to collect and disseminate quote sizes for customer orders and establish by rule quote sizes for broker-dealer orders.

As discussed above, under the Trade-Through Disclosure Rule, if a responsible broker-dealer fails to respond to an incoming order within the 30 seconds, the routing broker-dealer may execute its customer's order at its own inferior quote and would not be required to disclose the trade-through to its customer because the quote traded through was unavailable. The Commission also is adopting an amendment to the Quote Rule to require a responsible broker-dealer to respond to an order to buy or sell a listed option in an amount greater than its firm quote size within 30 seconds by either: (1) executing the entire order; or (2) executing at least that portion of the order equal to the applicable firm quote size and revising its bid or offer.[194] The Quote Rule requires responsible brokers and dealers to *immediately* execute an order to buy or sell listed options in an amount equal to or less than its firm quote size.[195]

1. Comments

One commenter stated that the lack of a Quote Rule in the options markets has impeded firms' ability to execute customer orders in an efficient manner while they explore posted quotes to see whether they are firm for the entire order or only for an order of minimal size.[196] Another commenter suggested that a true linkage cannot occur so long as market makers are permitted to refuse to honor displayed quotes.[197] Two commenters also believe that the Quote Rule will promote efficiency and increase customer confidence in our markets.[198] In addition, another commenter argued that the supposition that market makers would widen their spreads if their quotes were exposed to other market professionals is unjustified and unsupported by empirical data, and in any case, the public is more harmed by non-competitive un-real quotes than by wider spreads.[199]

Alternatively, one commenter stated that extending the Quote Rule to options will not significantly improve the current situation because the options markets are already subject to exchange-created firm quote rules, and despite such rules, public investors have often found that quotations in these markets are not firm, and neither are many of their transactions.[200] In addition, one commenter suggested that current competition among market makers for public customer orders is intense, but the proposed amendments will force the allocation of capital into areas of unacceptable risk, such as trading against other broker-dealers, and away from the facilitation of public customer orders.[201] Two commenters believed that to compensate for the increased exposure to broker-dealers the amendments will cause market makers to be less aggressive, widen spreads, limit quote size, and reduce overall liquidity to public customers, despite the fact that the proposal is suppose to draw more liquidity into the market by requiring market makers to be firm to broker-dealers.[202]

One commenter also believed there is no need for an exception to the Quote Rule for exchanges whose aggregate trading volume in a listed option is less than or equal to one percent of the total trading volume reported by OPRA.[203] This commenter argues that the possibility of a chilling effect on the liquidity of inactively traded securities does not justify the monitoring burden that the exception would impose on brokers, who would be forced to keep

[191] Exchange Act Rule 11Ac1–1(d)(2), 17 CFR 240.11Ac1–1(d)(2).

[192] Exchange Act Rule 11Ac1–1(d)(1), 17 CFR 240.11Ac1–1(d)(1). Exchange rules must require responsible broker-dealers to be firm for orders for the account of broker-dealers for at least one contract.

[193] Exchange Act Rule 11Ac1–1(d)(1)(iii), 17 CFR 240.11Ac1–1(d)(1)(iii).

[194] Exchange Act Rule 11Ac1–1(d)(3)(i), 17 CFR 240.11Ac1–1(d)(3)(i). A responsible broker's or dealer's applicable firm quote size would be its published quote size or, if a responsible broker or dealer has been relieved of the obligation to communicate its quotation sizes, the minimum firm quote size established by its exchange's rules.

[195] Exchange Act Rule 11Ac1–1(c)(2), 17 CFR 240.11Ac1–1(c)(2).

[196] *See* JPMorgan Letter.

[197] *See* Lek Letter.

[198] *See* Lek Letter and PCX Letter.

[199] See Lek Letter.

[200] *See* Brunelle Letter. This commenter noted that subsequent to execution, specialists or market makers frequently change the terms of the transaction or ''break'' the trade.

[201] *See* Susquehanna Letter.

[202] *See* Susquehanna Letter and Botta Letter.

[203] See JPMorgan Letter.

track of which quotes were firm and which, because of the one percent exception, were not.

2. Benefits

Amending the Quote Rule would reduce discrepancies between the treatment of quotes in the options markets and the equity markets.[204] Although options trading is not currently covered by the Commission's Quote Rule, each exchange's rules require their members' quotes to be firm up to a certain minimum size and establish the process for handling orders in excess of the exchange's firm quote size. Exchange rules also establish whether members' quotes must be firm for all orders or only some orders, such as only for public customer orders.

The Commission believes that applying the Quote Rule to the options market would provide a number of benefits. Firm quotes reduce uncertainty surrounding order routing decisions for broker-dealers that are seeking to fill customer orders at the best available price. If broker-dealers are confident that quotes are firm, investor orders may be routed to the market with the best price and receive an execution at that price. Under current practices, because broker-dealers cannot be confident that a price on another market is firm (due to existing market rules, including trade-or-fade rules), orders do not always receive the best available price. As discussed above, the staff estimates that five percent of all trades in the 50 most active multiply-listed classes took place at prices inferior to the best price quoted on a competing market during a one-week period in June 2000. Broker-dealers often state that such trade-throughs occur when market makers believe the better price on the other market may not be firm and the quote may "fade" if the broker-dealer were to attempt to execute against it. By requiring that posted prices be firm up to a published size, a great deal of uncertainty about order execution quality could be reduced. This would be true even if the quote were permitted to be firm for different sizes for customer orders than for broker-dealer orders.

In addition to providing certainty to broker-dealers making order routing decisions and seeking to fill orders at the best available price, extending the Quote Rule to the options markets may benefit broker-dealers by enhancing their ability to satisfy their regulatory obligations, including best execution. The Commission believes that the Quote Rule may help broker-dealers to satisfy their best execution obligations by providing firm quote information and reducing concerns about "fading" quotes. In addition, the Commission believes that enhancing the ability of broker-dealers to satisfy their best execution obligations may reduce the liability exposure faced by broker-dealers as to their best execution obligations.

The Commission also believes that the proposed amendments to the Quote Rule would bolster investor confidence in the options markets by ensuring that quotes made by market makers or specialists are available for a specified number of options contracts, thus providing greater certainty for investors. The Commission believes that as a result of increased investor confidence, more investors may trade options and thereby, increase volume and reduce spreads on the options exchanges. In addition, by requiring the quotations in listed options to be firm, the amendments may also lead to better-informed investors, which should increase investor confidence in the market.

Another benefit of applying the Quote Rule to options trading is that it would likely increase competition between markets. Because all quotes would be firm, a market participant would know that a posted quote would be recognized as firm. Therefore, the posted quote may attract order flow. The ability to attract order flow with a market-improving quote encourages intermarket price competition, which benefits investors. In addition, the Commission believes that its proposal would result in (1) fewer unexecuted investor orders due to quote changes after order arrival, or (2) fewer orders executed at prices less favorable to the investor than those prevailing at the time of order arrival.

3. Costs

Applying the Quote Rule to the options market would require exchanges to collect bids and offers from their members. This would not impose a significant burden on the exchanges because bids and offers generally are collected already by the markets and sent to (and disseminated through) OPRA. Currently, each of the options markets has rules that establish the maximum size of orders that its automatic execution system will execute. The exchanges would, however, be required to publish the size (or sizes, if different categories are used) for which their quotes must generally be firm. There are likely to be expenses incurred by the markets related to collecting and making available to quotation venders or periodically publishing their firm quote sizes.

Amendment of the Quote Rule to include options may require markets to incur one-time costs. For example, options markets may need to enhance surveillance and enforcement mechanisms to ensure that its members are complying with the Quote Rule. Further, options market makers and specialists may need to reevaluate and change their quotes in light of the obligation to be firm that would be imposed by the amendment to the Quote Rule.[205]

The Commission recognizes that these costs cannot be avoided, although the impact of the costs may be minimized to the extent that a market already has surveillance and enforcement procedures in place to monitor its members for compliance with the existing rules of the Commission and the exchange. However, the Commission believes that the current situation, wherein the options markets are permitted to fade from their quotes without consequence, pursuant to their trade-or-fade rules,[206] is no longer acceptable. Currently, options investors cannot fully rely on the disseminated quotation information on which they base their order routing decisions. The Commission believes that options investors deserve the same protections as equity investors and therefore, the Commission is adopting amendments to extend the coverage of the Quote Rule to the options market.

In addition, with respect to the concern raised by two commenters regarding the increased financial exposure of broker-dealers under the Quote Rule, the Commission notes that under the rule being adopted today, the options exchanges may establish different quote sizes for broker-dealers' orders than for customer orders. The Commission also believes that the options markets and options market makers should be permitted to make use of the one percent exception. The Commission is not persuaded that this exception, applied for years in the equity markets, will impose significant compliance burdens on market participants.

C. Conclusion

With the current expansion of multiple trading in options, the Commission is increasingly concerned

[204] The equities markets have been subject to a firm quote requirement since 1978. See Securities Exchange Act Release No. 14415, *supra* note and accompanying text.

[205] In the Proposing Release, the Commission stated that it was unable to quantify these costs and further solicited comments on these costs. *See* Proposing Release, *supra* note 7. No commenters explicitly addressed this issue.

[206] *See supra* note 33.

about customer orders, which are sent to one exchange, and executed at prices that are inferior to quotes published by another market. The Commission, therefore, believes that adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule are necessary at this time to encourage the removal of barriers to access to, and the use of efficient vehicles to reach, better prices on other markets. The Commission recognizes that there may be some costs associated with the implementation of these rules, however, the Commission believes that the likely benefits justify the possible costs.

VII. Effects on Competition, Efficiency, and Capital Formation

Section 3(f) of the Exchange Act[207] requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. In the Proposing Release, the Commission requested comment on these issues.[208]

With regards to the amendments to the Quote Rule, several commenters supported the Commission's proposals because they believed that the amendments would promote efficiency and enhance public confidence in the options markets.[209] Another commenter that argued that the current lack of a Quote Rule in the options markets impeded firms' ability to execute customer orders in an efficient manner because firms are forced to explore quotes to determine the size for which the quotes represent.[210]

The Commission believes that the amendments to the Quote Rule are necessary and appropriate in the public interest. The amendments to the Quote Rule should bolster investor confidence in the options markets by ensuring that quotes made by market participants are available for a specified number of contracts, thus providing greater certainty for investors. Similarly, the increased investor confidence should promote market efficiency and capital formation.

The amendments to the Quote Rule should also assist broker-dealers in making their best execution determinations. Further, the amendment to the Quote Rule will help to ensure that important information relating to the size associated with disseminated quotes is available to all market participants. This should promote market efficiency, competition, and capital formation.

With regards to the Trade-Through Disclosure Rule, the Commission believes that it will bolster confidence in the options markets by better informing investors about the quality of their executions and the implications of their broker-dealers' execution decisions. This increased investor confidence should promote market efficiency and capital formation. The Trade-Through Disclosure Rule also should help to minimize the number of customer orders that do not receive an execution at the best available quote.

The Commission also believes that the Trade-Through Disclosure Rule will assist broker-dealers in evaluating and complying with their best execution obligations. Moreover, the Trade-Through Disclosure Rule will provide an incentive to develop effective means of access between the markets to avoid trade-throughs. One commenter agreed, stating that the Trade-Through Disclosure Rule should assure that the options markets participate in either the Linkage Plan or that they will develop alternative plans that will effectively address and limit trade-throughs.[211] The Commission believes that this will result in the more efficient execution of orders in the options markets.

Section 23(a)(2) of the Exchange Act[212] requires that the Commission, when promulgating rules under the Exchange Act, to consider the impact any rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in the public interest. In the Proposing Release, the Commission noted that because both the proposed amendments to the Quote Rule and the proposed Trade-Through Disclosure Rule would apply equally to all relevant market participants, the Commission believed the proposals would not have any anti-competitive impact.[213] The Commission, however, requested comment on any anti-competitive effects of the proposals. The Commission did not receive any comments regarding the competitive impact of the Trade-Through Disclosure Rule. Thus, the Commission continues to believe that the Trade-Through Disclosure Rule adopted today will not have an anti-competitive impact on the options markets because the rules apply equally to each options market and other relevant options market participants.

The Commission did, however, receive comments on the potential competitive impact of the amendments to the Quote Rule. Several commenters that addressed the potential competitive impact of a Commission-mandated firm quote size believed that the Commission should not mandate a firm quote size because they argued that competitive market forces should dictate an appropriate firm quote size minimum.[214] Another commenter, however, argued that the Commission should mandate that the exchanges be firm for one contract for non-customer orders, which would permit the exchanges to compete by providing greater than the one contract minimum to attract non-customer order flow.[215]

While agreeing that the Commission should not dictate a firm quote size minimum, two commenters disagreed on whether the options exchanges or options market makers should be permitted to establish firm quote minimums.[216] For example, one commenter noted that the options exchanges compete for order flow by establishing firm quote guarantees.[217] Another commenter, however, argued that it is the options market makers that compete for order flow by establishing quote sizes for which they are willing to guarantee and that requiring the exchanges to set minimum quote sizes would eliminate this competition.[218]

As discussed above, the Commission agrees that the minimum firm quote size for each exchange should be determined independently by each exchange as a competitive issue and should not be dictated by government regulation. Further, the Commission also agrees that each disseminated quote must be firm for at least one contract. The Commission believes that this approach will encourage competition among the exchanges, which should benefit all investors.

The amendments to the Quote Rule adopted by the Commission today permit the options exchanges to establish by rule and periodically publish the sizes for which quotes will be firm for listed options. While one commenter argued that options market makers should be able to compete on this basis, the Commission believes, at this time, that it is appropriate to permit the exchanges to determine firm quote

[207] 15 U.S.C. 78c(f).

[208] *See* Proposing Release, *supra* note 7.

[209] *See* Lek Letter; PCX Letter; and CBOE Letter.

[210] *See* JPMorgan Letter.

[211] *See* PCX Letter. *See also* ISE Letter.

[212] 15 U.S.C. 78w(a)(2).

[213] *See* Proposing Release, supra note 7.

[214] *See* Botta Letter; CBOE Letter; PCX Letter; and Susquehanna Letter.

[215] *See* ISE Letter.

[216] *See* CBOE Letter and Botta Letter.

[217] *See* CBOE Letter.

[218] *See* Botta Letter.

sizes. Currently, the options exchanges, other than the ISE, do not accept quotes from each competing market maker on their floors. Further, OPRA does not, at this time, have the capability to accept and disseminate to vendors quotes with size, although it plans to have such capability early next year. Thus, the Commission believes that, at this time, it is appropriate for the exchanges to establish by rule and periodically publish the size associated with quotes in listed options. The Commission will continue to consider this issue as technology advances because the Commission believes that permitting individual market makers to compete on the basis of size on each exchange floor as well as among competing exchanges could further enhance the competitiveness of the options markets.

Finally, the Commission received two comments on the potential competitive impact of the two alternative proposals regarding establishing firm quote sizes for broker-dealer orders and customer orders. As discussed above, proposed Alternative A would have required that firm quote size minimums be the same for all orders, while proposed Alternative B would have permitted the options exchanges to establish different firm quote size minimums for broker-dealer and customer orders. One commenter, while supporting proposed Alternative A, suggested that it believed that distinctions between broker-dealer and customer orders would ultimately be eliminated through competitive measures of the exchanges.[219] Another commenter, who supported Alternative A, argued that broker-dealers play an important role in keeping prices fair and should be permitted to participate in the competitive pricing process.[220]

As noted above, the amendments to the Quote Rule adopted today permit the exchanges to establish different firm quote sizes for broker-dealer orders than for customer orders. Due to the tremendous number of options products that must be continuously quoted by options market makers and specialists, the Commission believes that this distinction is appropriate at this time. The Commission will continue to consider whether this distinction is appropriate. The Commission notes, however, that the amendments to the Quote Rule do not mandate that the exchanges establish different quote sizes for broker-dealer orders and customer orders, it only permits the distinction. Thus, the options exchanges are free to establish their individual firm quotes sizes for broker-dealer and customer orders as they deem appropriate.[221] The Commission thinks that it is likely that the options exchanges will compete on this basis.

VIII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with the Regulatory Flexibility Act.[222] It relates to the adoption of the Trade-Through Disclosure Rule and amendments to the Quote Rule. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with 5 U.S.C. 603 and was made available to the public.[223] The Commission is adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule substantially as proposed.

The Trade-Through Disclosure Rule, Exchange Act Rule 11Ac1–7,[224] will require a broker-dealer to disclose to its customer when the customer's order is executed at a price inferior to a price published by another market. However, a broker-dealer will not be required to provide such disclosure to its customer if it effects the customer's transaction on a market that participates in an approved linkage plan that includes provisions reasonably designed to limit customers' orders from being executed at prices that trade through a better published price, even if the better price is on a market that is not part of the linkage plan.

The Quote Rule, Exchange Act Rule 11Ac1–1,[225] currently requires exchanges to establish procedures for collecting from their members bids, offers, and quotation sizes for certain equity securities available to quotation venders. It also requires that the quotation information made available to vendors be firm, subject to certain exceptions. The amendments to the Quote Rule adopted by the Commission today apply the Quote Rule to options traded on a national securities exchange or an automated facility of a national securities association.

A. Need for, and Objectives of, the Rules

The significant increase in multiple trading that has occurred during the past year has dramatically altered the options trading environment and raised a number of issues, including new best execution challenges for broker-dealers. When an option is listed on only one market, broker-dealers do not have to decide where to route the order, and, consequently, satisfying their best execution obligations with respect to such options orders is less complex than when they must consider the relative merits of executing orders on several markets. Directly relevant to a broker's ability to get best execution for its customers is the ability to get the best price available. Currently, it is difficult to ensure that a customer order sent to one market will receive the best available price because there is no effective mechanism that allows broker-dealers on one market to access a better price displayed on another.

The Commission is adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule to help address this situation. The Trade-Through Disclosure Rule and the amendments to the Quote Rule are intended to bolster investor confidence in the options markets by better informing customers about the quality of their executions and the implications of their broker-dealers' execution decisions. The Trade-Through Disclosure Rule will require a broker-dealer to disclose to its customer when the customer's order is executed at a price inferior to the best-published quote. A broker-dealer will not be required to make this disclosure if the broker-dealer transacts the customer order on a market that participates in a Commission-approved intermarket linkage plan that has rules reasonably designed to limit trade-throughs, even when the better price is displayed by a market that is not a participant in the linkage plan. Amending the Quote Rule to apply it to the options markets should provide greater certainty about both options quotes and pricing generally in the options markets. The amendments to the Quote Rule, along with the Trade-Through Disclosure Rule, should assist broker-dealers in making their best execution evaluations.

The Trade-Through Disclosure Rule should help minimize the number of customer orders that do not receive an execution at the best available published quote. Further, the Trade-Through Disclosure Rule will assist broker-dealers in evaluating and complying with their best execution obligations. Finally, it will provide an incentive for options markets to develop effective means to access quotes on other markets to avoid trade-throughs.

The amendments to the Quote Rule also should bolster investor confidence

[219] *See* PCX Letter.

[220] *See* Lek Letter.

[221] Of course, Exchange Act Rule 11Ac1–1(d)(1) requires that exchange rules must require responsible broker-dealers to be firm for orders for the accounts of broker-dealers for at least one contract. 17 CFR 240.11Ac1–1(d)(1).

[222] 5 U.S.C. 604.

[223] *See* Proposing Release *supra* note 7.

[224] *See* Exchange Act Rule 11Ac1–7, 17 CFR 240.11Ac1–7.

[225] *See* Exchange Act Rule 11Ac1–1, 17 CFR 240.11Ac1–1.

in the options markets by ensuring that quotes made by market participants are available for a specified number of options contracts, thus providing greater certainty for investors. The amendments to the Quote Rule also will assist broker-dealers in making their best execution determinations. Further, the amendments will provide information to the market as a whole as to the various factors affecting the market, including the current levels of buying and selling interest.

B. Significant Issues Raised by Public Comment

As required by the Regulatory Flexibility Act, this section (i) summarizes the significant issues raised by public comments in response to the IRFA, (ii) summarizes the Commission's assessment of such issues, and (iii) states any changes made in the proposed rules as a result of such comments.[226]

No comments were received in response to the IRFA.

C. Small Entities Subject to the Rules

Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person) that is not a small entity.[227] The Commission estimates that as of December 31, 1999, approximately 41 Commission-registered broker-dealers were small entities that would be subject to the Trade-Through Disclosure Rule.[228] However, the Commission estimates that none of the 41 registered broker-dealers that would be considered small entities for purposes of the statute regularly represent options orders on behalf of their customers. In addition, the Commission notes that only those broker-dealers that are also options specialists or market makers will be required to comply with the amendments to the Quote Rule. As of December 31, 1999, our data indicates that only one broker-dealer that was a small entity was an options specialist or market maker.

The amendments to the Quote Rule also will directly affect the national securities exchanges that trade listed options, none of which is a small entity as defined by Commission rules. Paragraph (e) of Exchange Act Rule 0–10 [229] states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3–1.[230] The amendments to the Quote Rule also will directly affect national securities associations. There is one national securities association, which is not a small entity, as defined by 13 CFR 121.201.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The Trade-Through Disclosure Rule will require a broker-dealer to disclose to its customer at or before the completion of the transaction when an options trade executed for the customer was made at a price inferior to a price published by another exchange. The broker-dealer will not be required to provide such disclosure to its customer if the options trade was executed on an exchange that participates in an approved linkage plan that has rules reasonably designed to limit customers' orders from being executed at prices that are inferior to a published price, even if that better published price is on a market that is not part of the linkage plan.

The amendments to the Quote Rule will require a broker-dealer that is either a specialist or market maker to honor its quote for a size determined and published by the options exchange where the specialist or market maker is quoting. The amendments also will require national securities exchanges and national securities associations either to collect from their members the size associated with their quotes and disseminate that information to quotation venders, or to establish by rule and periodically publish such information.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entity issuers. In connection with adopting the Trade-Through Disclosure Rule and the amendments to the Quote Rule, the Commission considered the following alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

The Commission believes that different compliance or reporting requirements or timetables for small entities would interfere with achieving the primary goals of bolstering investor confidence, assisting broker-dealers in best execution determinations, and providing information as to the various factors affecting the market, including the current levels of buying and selling interest. For example, if all broker-dealers quoting prices in options are not required to comply with the amendments to the Quote Rule, investors and market participants would be unable to determine true buying and selling interest, undermining investor confidence and the ability of a broker-dealer to make best execution decisions. Further, broker-dealers would not be certain that a quote was firm without knowing whether the broker-dealer making the quote is a small broker-dealer. In addition, if all broker-dealers were not obligated to comply with the Trade-Through Disclosure Rule, all investors (those that are customers of small broker-dealers) would not benefit fully from the rule, potentially reducing the benefits of the rule.

For the same reasons, the Commission believes that exempting small entities from the rules, in whole or in part, is not appropriate. In addition, the Commission has concluded that it is not feasible to further clarify, consolidate, or simplify the rules for small entities. The Commission has used performance elements in the rules. Specifically, the rules do not require a broker-dealer to satisfy its obligations in accordance with any specific design, but rather provide each broker-dealer, including small entities, with the flexibility to select the method of compliance that is most efficient and appropriate for its business operations. The Commission does not believe different performance standards for small entities would be consistent with the purpose of the Trade-Through Disclosure Rule and the amendments to the Quote Rule.

Further, the Commission believes that none of the above alternatives is applicable to the amendment with regard to national securities exchanges or national securities associations. The markets are directly subject to the requirements of the rules and are not

[226] *See* 5 U.S.C. 604(a)(2).

[227] 17 CFR 240.0–10(c).

[228] The Commission's estimate of 41 small entities includes all of the registered broker-dealers that do not have relationships with clearing firms.

[229] 17 CFR 240.0–10(e).

[230] Exchange Act Rule 11Aa3–1, 17 CFR 240.11Aa3–1.

''small entities'' because they are all national securities exchanges or national securities associations that do not meet the definition of small entity. Therefore, the Commission does not believe the alternatives to the rules are applicable to the markets.

IX. Statutory Authority

The Commission is adopting the Trade-Through Disclosure Rule and amendments to the Quote Rule pursuant to its authority under Exchange Act Sections 3(b), 5, 6, 15, 11A, 17 (a) and (b), 19, and 23(a).

List of Subjects in 17 CFR Part 240

Brokers-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

Text of the Final Rules

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.11Ac1–1 is amended by revising paragraphs (a)(5), (a)(20) and (d); in the second sentence of paragraph (b)(3)(i) by revising the phrase ''under paragraph (c)(2)'' to read ''under paragraphs (c)(2) and (d)(3)'', and adding paragraphs (a)(26), (a)(27), (a)(28), (a)(29), and (a)(30), and (e) to read as follows:

§ 240.11Ac1–1 Dissemination of quotations.

(a) *Definitions.* * * *

(5) The term *consolidated system* means the consolidated transaction reporting system, including a transaction reporting system operating pursuant to an effective national market system plan.

* * * * *

(20) The term *reported security* means any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.

* * * * *

(26) The term *customer* means any person that is not a registered broker-dealer.

(27) The term *listed option* means any option traded on a registered national securities exchange or automated facility of a national securities association.

(28) The term *options class* means all of the put option or call option series overlying a security, as defined in Section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(29) The term *options series* means the contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

(30) The term *trading rotation* means, with respect to an options class, the time period on an exchange during which:

(i) Opening, re-opening, or closing transactions in options series in such options class are not yet completed; and

(ii) Continuous trading has not yet commenced or has not yet ended for the day in options series in such options class.

* * * * *

(d) *Transactions in listed options.*

(1) An exchange or association:

(i) Shall not be required, under paragraph (b) of this section, to collect from responsible brokers or dealers who are members of such exchange or association, or to make available to quotation vendors, the quotation sizes and aggregate quotation sizes for listed options, if such exchange or association establishes by rule and periodically publishes the quotation size for which such responsible brokers or dealers are obligated to execute an order to buy or sell an options series that is a subject security at its published bid or offer under paragraph (c)(2) of this section;

(ii) May establish by rule and periodically publish a quotation size, which shall not be for less than one contract, for which responsible brokers or dealers who are members of such exchange or association are obligated under paragraph (c)(2) of this section to execute an order to buy or sell a listed option for the account of a broker or dealer that is in an amount different from the quotation size for which it is obligated to execute an order for the account of a customer; and

(iii) May establish and maintain procedures and mechanisms for collecting from responsible brokers and dealers who are members of such exchange or association, and making available to quotation vendors, the quotation sizes and aggregate quotation sizes in listed options for which such responsible broker or dealer will be obligated under paragraph (c)(2) of this section to execute an order from a customer to buy or sell a listed option and establish by rule and periodically publish the size, which shall not be less than one contract, for which such responsible brokers or dealers are obligated to execute an order for the account of a broker or dealer.

(2) If, pursuant to paragraph (d)(1) of this section, the rules of an exchange or association do not require its members to communicate to it their quotation sizes for listed options, a responsible broker or dealer that is a member of such exchange or association shall:

(i) Be relieved of its obligations under paragraph (c)(1) of this section to communicate to such exchange or association its quotation sizes for any listed option; and

(ii) Comply with its obligations under paragraph (c)(2) of this section by executing any order to buy or sell a listed option, in an amount up to the size established by such exchange's or association's rules under paragraph (d)(1) of this section.

(3) *Thirty second response.* Each responsible broker or dealer, within thirty seconds of receiving an order to buy or sell a listed option in an amount greater than the quotation size established by an exchange's or association's rules pursuant to paragraph (d)(1) of this section, or its published quotation size must:

(i) Execute the entire order; or

(ii)(A) Execute that portion of the order equal to at least:

(*1*) The quotation size established by an exchange's or association's rules, pursuant to paragraph (d)(1) of this section, to the extent that such exchange or association does not collect and make available to quotation vendors quotation size and aggregate quotation size under paragraph (b) of this section; or

(*2*) Its published quotation size; and

(B) Revise its bid or offer.

(4) Notwithstanding paragraph (d)(3) of this section, no responsible broker or dealer shall be obligated to execute a transaction for any listed option as provided in paragraph (c)(2) of this section if:

(i) Any of the circumstances in paragraph (c)(3) of this section exist; or

(ii) The order for the purchase or sale of a listed option is presented during a trading rotation in that listed option.

(e) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

3. Section 240.11Ac1–4 is amended by revising paragraph (a)(10) to read as follows:

§ 240.11Ac1–4 Display of customer limit orders.

(a) *Definitions.* * * *

(10) The term *reported security* means any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan.

* * * * *

4. Section 240. 11Ac1–7 is added to read as follows:

§ 240.11Ac1–7 Trade-through disclosure rule.

(a) *Definitions.* For purposes of this section:

(1) The term *block trade* means a transaction in an option series that is for 500 or more contracts and has a premium value of at least $150,000.

(2) The term *customer* means any person that is not a registered broker-dealer.

(3) The term *effective national market system plan* shall have the meaning provided in § 240.11Aa3–2.

(4) The term *listed option* means any option traded on a registered national securities exchange or automated facility of a national securities association.

(5) The term *options class* means all of the put option or call option series overlying a security, as defined in Section 3(a)(10) of the Act (15 U.S.C. 78c(a)(10)).

(6) The term *options series* means the contracts in an options class that have the same unit of trade, expiration date, and exercise price, and other terms or conditions.

(7) The term *receipt* means, with respect to an order sent to an away market displaying a superior price, the time at which the order is either represented in the trading crowd or received by the specialist.

(b) *Broker-dealer disclosure requirements.* (1) Any broker or dealer that effects a transaction in a listed option for the account of its customer must disclose in writing to such customer, at or before completion of such transaction, as defined in § 240.15c1–1:

(i) When such transaction is effected at a price that trades through a better price published at the time of execution; and

(ii) That better published price.

(2) A broker-dealer shall not be required to provide the disclosure set forth in paragraph (b)(1) of this section if:

(i) It effects such transaction on a market that is a sponsor or participant in an effective national market system options linkage plan that includes provisions reasonably designed to limit the incidence of customer orders being executed at prices that trade through a better published price, including prices published other than by a linkage plan sponsor or participant, or

(ii) The customer order is executed as part of a block trade.

(3) A customer order is executed at a price that trades through a better published price if:

(i) The price at which an order to purchase a listed option is executed is higher than the lowest offer, at the time the order was executed, published pursuant to a national market system plan for reporting quotations in listed options; or

(ii) The price at which an order to sell a listed option is executed is lower than the highest bid, at the time the order was executed, published pursuant to a national market system plan for reporting quotations in listed options.

(4) Notwithstanding paragraph (b)(3) of this section, a customer order is not considered to be executed at a price that trades through a better published price if:

(i) The market on which the order is executed has verified that the market publishing such better price is experiencing a failure, material delay, or malfunction of its systems;

(ii) The quotations disseminated pursuant to the national market system plan for reporting quotations indicates that it is experiencing delays in transmitting such quotations;

(iii) Such better published price was published by an exchange whose members are relieved of their obligations under paragraph (c)(2) of § 240.11Ac1–1 because, pursuant to paragraphs (b)(3) or (d)(4) of § 240.11Ac1–1, such exchange is not required to meet its obligations under paragraph (b)(1) of § 240.11Ac1–1; or

(iv) The customer order is executed only after the market publishing the better price fails to respond to an order routed to it within 30 seconds of the order's receipt by that market.

(c) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any broker or dealer if the Commission determines that such exemption is consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets, or the removal of impediments to and perfection of the mechanism of a national market system.

Dated: November 17, 2000.

By the Commission.

Jonathan G. Katz,

Secretary.

[FR Doc. 00–30132 Filed 11–30–00; 8:45 am]

BILLING CODE 8010–01–P